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THE PROBLEMS OF FARM CREDIT

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HEARINGS

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

OCTOBER 23; NOVEMBER 13, 14, 19, AND 21, 1985

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THE PROBLEMS OF FARM CREDIT

WEDNESDAY, OCTOBER 23, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce; Representatives Vento, Kaptur, Carper, Shumway, Wortley, Bereuter, Ridge, McCandless, Grotberg, and McMillan.

Also present: Representatives Lehman and Leach.

Chairman **LaFalce**. This morning's hearing is on the potential spillover effects of farm credit problems on the national economy.

In the heady days of the 1970's, farm exports boomed. As a result, farmers had the rare luxury of both producing more, selling at higher prices. Operating profits for farmers rose and their land prices went up to reflect that flow of profits. Farmers were able to take on new debt just as rapidly as their land values rose.

That has all changed in the 1980's. The combination of loose fiscal policy and a tightening of monetary policy has created high real interest rates.

The dollar has become grossly overvalued and clobbered farm exports. Prices of farm products, particularly export crops, have dropped.

Farmers who took on substantial debt can no longer operate at a profit. Land prices in Iowa and Nebraska have been cut in half. The Department of Agriculture has estimated that of the 636,000 commercial-size farms, 31,000 are insolvent; they have debts that exceed assets. Another 25 percent of those farms have too much debt to operate at a profit.

As a result of these trends, lenders are finding more delinquencies on payments by farmers. Two-thirds of the 52 commercial banks that closed this year in the first half of this year were banks that had loaned more to farms than the national average.

Our witness from the Federal Reserve, Emanuel Melichar, has done some striking tabulations from the USDA's financial survey of farmers. He has farmers according to their current debt-to-asset ratio and their recent return on assets.

His results are shown on tables 3, 4, and 5 of his prepared statement today. The tables indicate that 10 percent of farmers are already in serious financial trouble and another 7 percent are headed in that direction.

Not coincidentally, the 10 percent of farmers in the worst financial shape owe 23 percent of the roughly $100 billion in debt owed by commercial farm operators. The 7 percent of farmers headed for serious financial problems owe another $21 billion in debt.

Mr. Melichar's tabulations also show us which lenders are holding this vulnerable debt. Roughly one-fifth of the farm credit system's loans to commercial farm operators is owed by those in financial trouble.

Commercial banks have lent $50 billion to farmers, of which $12.5 billion has gone to farmers in the worst shape and another $6.5 billion to farmers probably headed for financial trouble.

Not surprisingly, "ag banks," those that have more loans to farmers than the national average, comprise a large proportion of the commercial banks that have been forced to close this year.

The Farm Credit System is a farmer-owned cooperative system that includes land banks, production credit associations, and banks for cooperatives. Most of the System's loans have variable interest rates which have been forced up by two trends.

First, the increase in the System's troubled loans has required it to make greater provision for loan losses. Second, the System as a whole gets funds from the bond market. As the problems of the System have been getting more attention, the interest rate it must pay to buy money has been rising.

This hearing will not dwell on whether or what kind of mechanism the Government might create, much less whether or how much money the Government might provide, in the interests of a healthy agricultural economy and sound financial system.

This will be a factfinding hearing, and at this hearing, we want to focus on issues that we in Congress must better understand before trying to consider or fashion remedies.

If present trends continue, what can we expect for farm lenders, their borrowers, and financial markets generally? What are the reasons to consider helping farm lenders? Does the stress faced by farm lenders also hurt farmers and the rest of the economy through the financial markets?

Are there reasons to help one specific type of farm lender, specifically the Farm Credit System, but not others? What are the competitive relationships between the Farm Credit System, commercial banks, insurance companies, and other farm lenders?

We have four witnesses today who are recognized experts in the field of agricultural credit—Mr. Melichar whom I have already mentioned from the Federal Reserve; Prof. Michael Boehlje, chairman of the Department of Agricultural Economics at the University of Minnesota's Department of Agricultural Economics; Dr. George Irwin, Associate Deputy Governor and Chief Economist of the Farm Credit Administration; and John Urbanchuk, director of International Agriculture Service at Wharton Econometrics.

Now, I would like to call on our distinguished ranking minority Member for any statement he might have.

Mr. Shumway.

Mr. SHUMWAY. Thank you, Mr. Chairman.

I would like to extend my welcome to our distinguished panel of witnesses. No doubt, their testimony today will open many eyes to the very current, indeed, critical, problems underlying our Nation's agricultural economy.

Forty years ago, in Rodgers and Hammerstein's play, "Oklahoma," America's heartland was full of optimism as it joyfully proclaimed "the corn is as high as an elephant's eye," and "everything is going my way."

Yet, today, in the movie, "Country," not only is the corn, but the debt, as high as an elephant's eye, and the local farmer is valiantly fighting for his family's land, and its American values against the inevitable foreclosure.

How in this 40-year period could we have come through the "best of times" and now face the "worst of times?" What factors have generated the vortex of the agricultural economy's downward spiral? Why is this fall's harvest, the most bountiful one to date, also accompanied by commodity prices decreasing and farm debt increasing at precipitous rates?

The answers are not entirely clear but certain elements have united to place this sector of our economy at a critical juncture. I think everyone can agree on several factors.

First, the problems in agriculture today have deep roots in the excesses of farmers and their lenders that, in turn, were created by the inflationary environment of the 1970's.

Second, this was also an unusually prosperous era for U.S. agriculture. Farmers' production and investment decisions were often made, and willingly financed, by creditors, on the assumption that inflation would continue and that foreign markets for U.S. grains and soybeans would continue to grow at the phenomenal 10-percent annual rate of that decade.

Indeed, pasture land was planted fence to fence with crops in an effort to capitalize on the booming export markets. Technological advances, such as production-enhancing chemicals, expanded production, as did double-cropping and irrigation.

As the optimism swelled, so did the farm land values, rising at the meteoric annual rate of 12 percent, despite the rapidly rising interest rates in the late 1970's. Farmers, fortified by both huge equity gains and earnings that outstripped inflation, went on a buying spree.

Machinery, equipment, buildings, land improvements; nothing was too expensive. And lenders, lulled by the same sense of security, were all too willing to finance the growing proportion of these purchases, operating expenses and capital investments.

Unfortunately, the dream world of the 1970's gave way to the realities of the 1980's. Export markets have shrunk due to the rising value of the dollar, slow economic growth abroad, expanded agricultural production in other areas of the world and realignment of trade patterns.

Widespread drought problems in 1980 and again in 1983 had significant repercussions for farm earnings. The flip-flop in monetary and fiscal policies also contributed to the changing realities.

Needless to say, the clarity of hindsight allows us to see that the bubble had to burst. That said, however, we must move forward, assess the extent of the damage to the agricultural sector and its lenders and determine what, if any, measures should be taken to repair this part of our economy.

The data is still not complete; however, preliminary numbers are painful enough. And the ramifications on the rest of our economy may be enormous, in terms of future growth and employment, productivity, competitiveness and stability.

Adjustments will have to be made and these, too, will be painful not only for the agricultural community but also for the economy.

I am hopeful that our witnesses today will be able to shed some light in this respect and I look forward to their testimony.

Chairman **LaFalce**. Mr. Bereuter?

Mr. **Bereuter**. I do not have a prepared statement. I do want to thank you for taking the leadership and conducting these hearings.

These hearings are crucial. Agricultural credit conditions are as strained in my District as they are any place in the Nation.

I am pleased to see you set the tone for the hearings by your initial comments, and that you referred to the task before us as focusing on the trends and prospects in agricultural credit generally while not restricting the hearings to the Farm Credit System.

I am deeply concerned about the condition of the Farm Credit System and hope to find some solutions to their problems. I also think that we should not neglect the other types of agricultural credit institutions that exist. For example, the commercial agricultural banks.

I would like to quote from a letter I received, dated October 17 of this year, from E.F. Backlund, president of the Independent Bankers Association of America.

He says, and I quote him,

> It would be patently unfair for commercial agricultural banks to be permitted to continue to fail in record numbers, record since the 1930s, and at the same time, relieve the cooperative, largely tax-exempt farm credit system of its loan losses through a direct and unilateral infusion of money from the Federal Treasury.

I agree with him. Furthermore, agribusiness leaders and farmers in my State agree with that statement, regardless of what their source of credit may be.

It is important that we not have an adversarial relationship between the institutions and sector that provide agricultural credit, but that we look at the problem as you have attempted to draw our attention to today, in a comprehensive basis, because it is tied to a very basic problem in exports today.

I look forward to the testimony of our witnesses.

Chairman **LaFalce**. Thank you very much.

We will go to the testimony of the witnesses, and our first witness will be Mr. George Irwin, Associate Deputy Governor and Chief Economist of the Farm Credit Administration.

STATEMENT OF GEORGE D. IRWIN, ASSOCIATE DEPUTY GOVERNOR AND CHIEF ECONOMIST, FARM CREDIT ADMINISTRATION

Mr. **Irwin**. Thank you, Mr. Chairman.

I appreciate the opportunity to visit with you today on behalf of the Farm Credit Administration. We are the regulator of the Farm Credit System, which I will be talking about here this morning.

We could summarize the nature of the Farm Credit System by describing it as a system to tap funds of savings after they have been assembled in the national money markets and then bring them back out into the local areas.

There has been a very significant deterioration in the strength of this system, as I think you are all aware. What I have done in this statement is to summarize some financial information as of June 30, which is the last complete information available.

I have attempted to discuss the economic forces involved, as a factor affecting what can or should be done, and I have summarized a little bit on the potential of exposure of system institutions.

As you are also undoubtedly aware, our conclusion is that the problems are likely to continue, and that some form of Federal assistance is likely to be required to deal with them.

It is important to put in perspective that the U.S. farm sector is undergoing a very profound transformation under stress conditions. We have seen a reversal of economic forecasts for agriculture for the rest of the 20th century in three major dimensions:

The expectation of the 1970's was for expanding world demand, constraints on supply expansion, and generally rising agricultural prices; it is now clear that worldwide agricultural supply response has negated the shortage scenario.

The result is downward pressure on commodity prices and unwinding of land price levels which were based on expectation of shortages.

The use of agricultural land both as a store of value against inflation and as a speculative investment in the 1970's also caused capital gain income streams capitalized far into the future by some farmers. These, too, are being unwound.

The anti-inflation strategy of the early 1980's, relying almost totally on strong monetary restraint with continued fiscal stimulus, produced high real interest rates, a high exchange value of the dollar, and extreme stress on the capital intensive and export sectors, including agriculture, which are bearing the brunt of the readjustments.

The speed of this policy turnaround has probably exacerbated the problems in adjusting to the first two forces.

The result for farm businesses is a reduction in the ability to carry financial leverage in the 1980's. Farmers carrying a very large portion of the agricultural debt must adjust to lower financial leverage, and a portion will not be able to do so.

The problem was worsened by the general perception for the first 2 or 3 years of this decade, that this was a temporary condition we were in, and that the right answer was forebearance, to see people through a temporary dip until prosperity conditions of the seventies returned.

We now see that was not so, and we have some additional adjustment problems, simply because of that slowness of the change in the perception of what is really out there.

I want to emphasize fairly strongly that the size of adjustment in agricultural asset values is practically unprecedented. We have at least five Midwestern States where the drop in land values by the end of this year, which will be for a 5-year period, will be in the nature of 50 percent.

Looking from the other direction in 1978 or 1980, ask yourself if a 50-percent loan on a farm mortgage would have been considered reasonable.

I think the conclusion has to be macroeconomic factors have as much to do with the current situation as does the lending practice, soundness of lending practice of any lender we talk about.

It also suggests that, for you members of the Banking Committee, the problem in the Farm Credit System is somewhat different from that of commercial banking. That is due to the overwhelming importance of the farm real estate mortgage through the Federal Land Bank System in the farm credit family, and the lack of a comparable kind of lending in the commercial banking sector.

What about the situation in the Farm Credit System? Viewed in total, it appears to be relatively well capitalized. Up until this year, earnings have more than covered losses and capital has grown.

There have been lots of local associations having to restructure, and two of the 37 banks have already received transfers of funds internally from their sister banks. Total capital is about $9.75 billion in the banks, and $3.75 billion in the PCA system. Net worth is equally divided between earned net worth and equity in the form of borrower stock. Since this is a cooperative system and that stock at risk causes unique problems and concerns. It is a condition of being a borrower.

In addition, there is a $1.1 billion, roughly, set aside in the allowance for loan loss account as of June 30.

Those numbers include the entire Farm Credit System, including the banks for cooperatives and that particular segment, as I have detailed in the statement, is not in as great a difficulty.

Therefore, the other two are in relatively worse problems. During the second quarter of 1985, we saw a very major pattern of increasing loan chargeoffs. The second quarter level of bank chargeoffs nearly equalled the total for the entire previous year.

For the year 1984, chargeoffs were $428 million. In addition, nonperforming loans, which had not reached the stage of chargeoff, had also grown very rapidly.

The farm mortgage loans of the land banks were reported to include 10.7 percent nonperforming loans. On June 30, the PCA loans to farmers were 12.1 percent.

Let me emphasize what we mean by nonperforming. It means a borrower has not been able to meet all the terms of the original loan agreement he had with the lender. That is a rather wide range of accounts. It includes loans that have already been restructured, partly written down perhaps, or interest rate adjusted, and may be expected to be collected in full.

At the other extreme, it may include loans in foreclosure and liquidation. And it includes just about anything in between. A gross misinterpretation has been made in some quarters that somehow all of this is uncollectible. Not nearly an accurate statement.

Deterioration in performance during this second quarter was a very significant factor.

I have cited the numbers in the written text but the point is, normally loan quality figures follow a seasonal pattern in which they decline at the December 31 and March 31 reporting periods, and they improve during June and September.

That is related to the fact of the agricultural production cycle being annual and most loans payments schedule to match. This time, the June 30 figures were dropping. They were worsening and that deterioration will continue again in the September 30 figures to be released soon.

It has been our feeling that the accounting practices must make provision, and must classify these kinds of situations when they are known to protect the investors in the securities and to protect the stockholders. Therefore, we have spoken out on the situation.

As of June 30, net income for the System for 1985 was projected actually to be a loss of $400 to $600 million, and this would be the first loss in recent history.

The reason for that is primarily increasing provisions have to be set aside for expected losses on accounts that are still on the books, although operating income is also under pressure from keeping nonaccruing loans and from carrying increasing amounts of acquired property in the System.

One also has to look ahead and ask what are the prospects for the future? Can we expect conditions again to reverse, to turn more favorable? Will there be a return of positive earnings in 1986?

You have to look at the restructuring not yet done, and the economic prospects for the next 3 or so years to make a judgment about this, and that is what we have done in arriving at where we are right now.

I have included in my text numbers from the USDA survey and various other sources, but I assume from your opening comments, and those I can expect from my fellow panelists, it is not necessary to go through them in any detail.

You cannot know exactly the size of the problem. We are continuing to get people identifying the specific size. All reach the same general conclusion. The problem is very, very substantial.

My comments also include some things about commercial farmers, farmers within the Farm Credit System, and about all farmers.

We think the situation right now is that a significant portion of the Systems' loans are to commercial farmers who are in the categories most likely to be in very great difficulty.

If you look at those that have negative cash flows by a severe definition of negative and those that have leveraged of over 70 percent, there is probably $7.5 billion in loans held by those people.

A continuation of past trends in farm income and agriculture asset value declines could cause these numbers to nearly double. We are talking about a system with some $72 to $75 billion in loans outstanding.

I think the external economic environment for agriculture reinforces the view that we are not through our problems yet. We have extremely large crops in prospect for 1985, being harvested right now.

They have pushed down commodity prices. The only stabilizing factor there is that the price support program puts a floor under prices for large numbers of producers, and therefore, will aid cash flow this fall.

I think large supplies are practically assured for the next 2 or 3 years in the agricultural sector, and that keeps downward pressure on prices and makes the levels established in the 1985 farm bill very significant for understanding what is going to happen to the credit situation.

What we have concluded is that the System retains substantial gross earnings capacity, and it has substantial capital assets, but it probably does not, in view of these trends, have the internal resources necessary to see itself through until conditions stabilize, and therefore, it won't remain as a viable financial institution.

We think the Federal Government will have to provide some mechanism for sharing these losses, if we want the Farm Credit System to be viable in the future. It is not an immediate solvency problem, but one down the road 18 to 24 months.

The more immediate concern is to the System's funding ability rather than its capital base. It is a liquidity problem. The Farm Credit System raises its funds by selling securities. And in recent weeks, we have seen the market become aware of these problems, increased risk in the System's portfolio and seen an increased cost of funds, a shift in the composition of buyers.

We have seen a shortening of the maturities which are marketable and this is an environment in which further adverse information could well precipitate some kind of difficulty in selling securities.

We do have substantial amounts of liquid reserves if marketability is a short-term problem, but there is not a way around it, if it is of longer duration, other than some kind of public assistance.

In other words, we are saying that we think that the liquidity problem, the potential, is much more immediate and significant at the moment than the solvency problem, but one is following the other.

The farm debt problem clearly reflects the situation of agriculture, and clearly reflects the fact that the Farm Credit System is diversified only within the agricultural sector, and by Congress' charter can do no more than serve the agricultural sector.

Both agriculture credit institutions and the farming sector are going through a period of transition, adjustment to a new kind of economic reality.

Both of them can over time make responses, but unless there is some short-term transition assistance, the magnitude of the change is rather disruptive.

It is a particular problem in the case of the land markets, because the potential amount of resources that have to be put into new hands are really very large in relation to the size of those markets. Current conditions, until they stabilize, do not provide a lot of incentive for potential buyers to be in any hurry in getting into that market.

The long-term ability of American agriculture to produce and compete in world markets will be diminished by excessive loss of rural financial business infrastructure, and wealth in the rural sector.

We think that it is in the national interest to provide some kind of assistance structured to strengthen agriculture, to improve its responsiveness to market forces, and if such assistance is provided under conditions that will minimize the likelihood of some kind of recurrence of this kind of a problem.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Irwin follows:]

STATEMENT OF GEORGE D. IRWIN

ASSOCIATE DEPUTY GOVERNOR AND CHIEF ECONOMIST

of the

FARM CREDIT ADMINISTRATION

before the

ECONOMIC STABILIZATION SUBCOMMITTEE

of the

HOUSE COMMITTEE ON BANKING, FINANCE

& URBAN AFFAIRS

October 23, 1985

Mr. Chairman, I appreciate this opportunity to appear before your committee on behalf of the Farm Credit Administration (FCA) to discuss the status of the Farm Credit System (System). There has been significant deterioration of the System's financial position. I will summarize financial information about the System as of June 30, 1985, discuss the economic forces affecting the System, and summarize our studies of the potential exposure of System institutions to an increase in loans to commercial-sized farm operators that must be placed in a nonaccrual status. Our conclusion is that problems will continue and that some form of Federal assistance will be required to deal with them.

The U.S. farming sector is undergoing a profound transformation under stress conditions. We have seen a reversal of economic forecasts for agriculture for the rest of the 20th century in three major dimensions:

- The expectation of the 1970s was for expanding world demand, constraints on supply expansion, and generally rising agricultural prices; it is now clear that worldwide agricultural supply response has negated the shortage scenario. The result is downward pressure on commodity prices and unwinding of land price levels based on expectation of shortages.

- The use of agricultural land both as a store of value against inflation and as a speculative investment in the 1970s also caused capital gain income streams capitalized far into the future by some farmers. These, too, are being unwound.

- The anti-inflation strategy of the early 1980s, relying almost totally on strong monetary restraint with continued fiscal stimulus, produced high real interest rates, a high exchange value of the dollar, and extreme stress on the capital intensive and export sectors (including agriculture), which are bearing the brunt of the readjustments. The speed of this turnaround has probably exacerbated the problems in adjusting to the first two forces.

The result for farm businesses is a reduction in the ability to carry financial leverage in the 1980s. Farmers carrying a very large portion of the agricultural debt must adjust to lower financial leverage, and a portion will not be able to do so. As many as 35 to 45 percent of the 1.7 million farming operations covered by the USDA survey will require major restructuring of their debt and an additional 10 to 15 percent will not be able to continue farming. Because System banks and associations lend to the farm sector exclusively, the pressures on agricultural producers impact immediately and directly on System loan portfolios. A large proportion of farm debt is owed to System institutions by member-borrowers who require major restructuring (partial or total liquidation) at a time when asset prices and markets are reflecting sharply reduced expectations. The resulting loan delinquencies and losses far exceed risk premiums incorporated into interest rates, eroding loss reserves built up over a 50-year period, and threatening capital positions. The impact is multiplied by the normally high degree of leverage of the System institutions themselves.

I cannot overemphasize that the size of the adjustment in agricultural asset values is unprecedented -- perhaps as much as a 50-percent drop in the past 5 years. This causes enormous problems for farmers whose financial leverage level was based on expectations of the 1970s. It creates a uniquely higher level of problem for farm real estate mortgages; the area in which the System is the predominant lender.

Condition of the Farm Credit System

Viewed in total, the System appears to be relatively well capitalized. Earnings have more than covered losses and capital has grown until this year. At the same time, individual banks and associations have been experiencing historically unprecedented losses. Recent losses have been heavily concentrated in the Federal intermediate credit banks (FICBs) of the Omaha and Spokane Districts, but a number of Federal land banks (FLBs) are now also experiencing sharp increases in losses. For example, over the 4 years ending April 1, 1985, farm real estate values have fallen $180 billion in 10 of 12 districts. Eighty percent of the drop came in Omaha, St. Louis, Louisville, and St. Paul. Most states in the Cornbelt had land price drops of 40 to 50 percent in the 4 years 1980-84. This magnitude of drop creates special pressures on the System because the Federal land banks are the dominant institutional source of real estate loans.

Total net worth. Total net worth as of June 30, 1985, stood at $9.26 billion for the 37 banks, compared to $9.24 billion as of December 31, 1984. PCAs had a net worth of $3.75 billion, a decline of 1.1 percent during the second quarter. This net worth is divided roughly equally between borrower stock equity and earned net worth. An additional $1.1 billion was set aside in the allowance for losses account.

These figures representing the condition of the 37 banks include the banks for cooperatives (BCs). The BCs are generally experiencing less difficulty with only 6.6 percent of the loan volume of $8.343 billion in a nonperforming status and only $30.2 million listed as nonaccrual loans. Net income for the second quarter was $25.9 million after making provisions for losses totaling $3.8 million. Also, as of June 30, the total net worth of the 12 BCs represented 12 percent of their assets.

Loan chargeoffs. During the second quarter of 1985, there has been a pattern of increasing loan chargeoffs. Thus, the chargeoffs recorded for the second quarter for the 37 banks nearly equaled chargeoffs recorded during the entire previous year. Chargeoffs on loans recorded during the quarter totaled $119.3 million for the 37 banks and $120.8 million for the production credit associations (PCAs). Additionally, Federal land bank associations (FLBAs) absorbed $5.9 million in chargeoffs on FLB loans. These figures compare to $41.9 million in bank chargeoffs and $19.2 million in PCA chargeoffs for the first quarter. Chargeoffs for the year ending 1984 were $122.4 million in the 37 banks, $285.9 million for the PCAs, and $19.8 million for the FLBAs.

Nonperforming loans. FLBs reported 10.7 percent of their farm real estate loans nonperforming as of June 30, 1985. Nonperforming means that the borrower has been unable to meet all of the terms of the original loan agreement. It includes loans that have already been restructured and are expected to be paid in full, loans in foreclosure or liquidation, and all categories between these two extremes. These loans totaled $5.442 billion, of which $1.854 billion are no longer accruing interest. In addition, nonperforming loans comprised 23.6 percent of the FICB loans outstanding on June 30. Nonperforming loans totaled $3.829 billion of the total FICB volume of $16,202 billion with $128.8 million in a nonaccrual status. These FICB loans are primarily to troubled PCAs. For the same quarter PCAs held nonperforming loans of farmers totaling $2.080 billion -- 12.1 percent of loans outstanding with $678.6 million in nonaccrual status.

Deterioration in loan performance was very significant. At the end of the first quarter, 11.2 percent of the FLB loans, 14.7 percent of the FICB loans, and 15.7 percent of the PCA loans were nonperforming. It should be noted that repayment of agricultural loans is seasonal, with significant changes in loan status normally identified in the December and March quarters. Improvement in statistics usually occur during the June and September quarters. Therefore, significant weakening of the financial data provided by the banks and associations for the second quarter of 1985 was particularly worrisome. The large crop in prospect practically assures that deterioration will continue in the third quarter statistics, which are now being compiled.

Net Income. We are now projecting net losses for the System for 1985 at $400 to $600 million, the first losses in recent history. This compares to net income of $489.2 million for the 37 banks for the 1984 calendar year. System earnings are being eroded primarily by increasing amounts which have to be set aside in provision for expected losses, although operating income is also under pressure. For the 12 FLBs, net income for the second quarter was reported at $2.8 million after provision for losses totaling $79.9 million. Net income for the quarter totaled $6 million for the FLBAs. FICBs reported $6.9 million for the second quarter after making provisions for losses totaling $22.9 million. PCAs reported an aggregate net operating loss of $12.6 million after provision for losses of $54.6 million.

Prospects for the Farm Credit System

Can we expect conditions to again reverse? Will there be a return to net earnings in 1986? We need to examine both the amount of restructuring yet to be done in the loan portfolio and the economic prospects in order to make a judgment. As you are already aware, our conclusion is that the most likely prospect on both counts is continuing deterioration.

The most recent USDA survey (AIB 495, July 1985) representing 1.7 million farm operators indicates that about 214,000 farmers -- about 13 percent -- are experiencing financial stress due to the combination of a high debt load (a debt-to-asset ratio of 40 percent or more) and the inability to generate enough cash-flow to pay expenses (including family living expenses and scheduled principal and interest repayment). Nearly 92,000 are experiencing extreme stress with debt-to-asset ratios over 70 percent, and insufficient cash-flow to meet expenses.

However, because much of the farm debt is held by "commercial" size operators -- those with annual gross sales over $40,000 -- the crucial measure of stress on System institutions relates to the 129,000 commercial-size farmers with debt-to-asset ratios over 40 percent. These farmers owe $46.6 billion, or 22 percent, of the outstanding farm debt. Furthermore, a significant amount of this debt falls in the extremely stressed category. At this time, $12.9 billion in loans are held by commercial farmers with debt-to-asset ratios in the 70-100 percent range, and $10.7 billion in loans are held by commercial farmers with debt-to-asset ratios above 100 percent (technically insolvent borrowers). So, $23.6 billion of the total farm debt is owed by farmers who will have to liquidate their operations. The amount of loss on such liquidations is difficult to estimate, but it will be significant to both farmers and lenders. Under a pessimistic outlook for asset values and incomes, more and more operators will find themselves moving to extremely stressed levels. A particular aspect of this concern is the temporary overloading of land resale markets, which threatens to drive land prices well below equilibrium levels and threaten viability of still more operators.

The effect of this situation on the System is profound. The USDA survey included information about a significant portion of the System's loans to commercial farmers. It indicates that approximately $4 billion is held by operators with debt-to-asset ratios between 70 and 100 percent, and $3.5 billion is held by operators who are technically insolvent. A continuation of past trends in farm income and agricultural asset-value declines could cause these numbers to nearly double. The external economic environment for agriculture reinforces such a view. Extremely large crops for 1985 have pushed down farm commodity prices and made it likely that we will be in surplus situation for at least 2 or 3 years. Commodity price floors will be set by the 1985 Farm Bill, and this will determine loan repayment capacity. We have concluded that while the System retains substantial gross earnings capacity and capital assets, it does not have the internal resources necessary to absorb expected losses in the next 24 months. The Federal Government will need to provide mechanisms for sharing these losses with farmers and their lenders if the System is to survive and serve farmers of the future.

System Funding

The most immediate threat is to the System's funding ability rather than to its capital base. The System raises the funds it lends to farmers by selling securities in the Nation's money and capital markets. In recent weeks, there has been an increase in the market's perception of the System's portfolio risk that has resulted in an increase in the System's cost of funds; a shift in the composition of buyers and a shortening of the maturities which are marketable. Further adverse information could very well precipitate difficulty in selling securities. Although the System has substantial liquid reserves, if the marketability of its securities were impaired and not quickly restored, the System would be forced to either liquidate a large part of its portfolio or default on its obligations to investors. Should this happen, the System would be unable to act as an intermediary for moving funds from the savings surplus sectors of the economy to the savings deficit agricultural sector. It would then cease to function as a dependable and essential source of credit to food and fiber producers, which is the reason why it was established by the Federal government. In short, any amount of capital base in the System is adequate only as long as securities markets think it is adequate. FCA's action in calling attention to the situation early was intended to provide the time necessary to work out an acceptable solution. Evidence that such a solution is coming may well be critical to maintaining liquidity in the period ahead.

The farm-debt problem reflects the situation of agriculture. Agricultural credit is undergoing a period of transition and adjustment to the reality of deflation, deregulation in the financial markets, and U.S. integration into changing world food and fiber markets. Agriculture can respond over time to broad changes in economic conditions, but unless changes in short-term public policy are made, agriculture may well decline beyond the level of adjustment required by present market realities. It is important to understand that the agricultural sector is going through a more profound realignment than would normally occur through a business cycle, and that there are broader consequences than those that are being experienced by farmers who speculated on continued inflation.

The long-term ability of American agriculture to produce and compete in world markets will be diminished similarly by the loss of rural financial and business infrastructure and wealth. In the view of the FCA, the national interest will be best served if Federal assistance is made available to the System, if it is structured to strengthen agriculture and improve its responsiveness to market forces, and if it is provided under conditions that will minimize the likelihood of a recurrence of the System's distressed conditions.

Chairman LAFALCE. Thank you very much, Mr. Irwin, for your excellent statement.

We will now hear from Mr. Melichar of the Federal Reserve System.

STATEMENT OF EMANUEL MELICHAR, SENIOR ECONOMIST, ECONOMIC ACTIVITY SECTION, DIVISION OF RESEARCH AND STATISTICS, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. MELICHAR. Mr. Chairman, I am pleased to have this opportunity to discuss farm sector financial experience and to present the most recent data on farm loan experience at banks.

I am especially happy to be able to include a new analysis of the financial position of farmers, an analysis which represents a significant improvement over previously published national analyses.

I will be referring to several charts and tables in my prepared statement.

Severe financial problems have been concentrated among those farmers who were highly leveraged as the boom of the 1970's ended, usually because they had expanded their operations.

However, many highly leveraged farmers are not in financial trouble, because they are operating profitably enough to service their debt, as will be shown by a new analysis of the financial position of commercial farm operators that I will present in the next section of this report.

First, however, I will review briefly the aggregate experience of the farm sector.

The key aggregate returns derived in table 1 are shown in chart 1. In addition to providing an overview of financial experience, these sector totals and averages reveal, as I will discuss, the roots of some of the diversity in financial experience of farmers.

Three key observations can be made. First, although net income before interest payments has fluctuated considerably in recent years, its general level has not changed much since the beginning of this decade.

This implies that farmers with little or no debt generally have seen their income maintained. However, as shown by the corresponding solid line in the lower panel of the chart, their average rate of return has been relatively low.

Second, net income after interest payments, the dashed line in the upper panel, has been averaging near zero in the 1980's. This implies that farmers with average profitability and average debt have been just able to meet their interest charges from current earnings, whereas those with average profitability but heavier debt have seen their earnings fail to cover their debt service.

Third, income in the 1980's has fallen far short of the expectations that were capitalized into land prices during the preceding decade. Consequently, the huge capital gains experienced in the 1970's, indicated by the vertical bars in the upper panel, have given way to huge capital losses.

Thus, in the lower panel, the rate of total return, which includes both income and capital gains, has remained negative since 1980.

But the swing in wealth has been mainly experienced by owner-operators of extensive acreage, rather than by tenant operators or by farmers whose operations use relatively little land.

While presenting a generally deteriorating picture, the aggregate data reveal some strengths as well as weaknesses. But they do not address two important questions: What proportion of farmers is in financial trouble, and how much of the debt does this group owe?

The foregoing review of aggregate relationships has indicated, however, that several income and balance sheet measures should be considered jointly in assessing the financial position of individual farmers.

The USDA's newly improved annual Farm Costs and Returns Survey is the only national data base that provides the individual data on income, expenses, assets, and debt required for such an analysis.

In a cooperative effort with the Economic Research Service, USDA, we cross-classified these 1984 data for "commercial" farmers—those with sales of $40,000 or more in 1984—by four factors: Return on assets, return on equity, amount of equity, and debt/asset ratio.

Then, using this tabulation in conjunction with the criteria shown in table 2, the farmers were grouped into four financial positions: Good, fair, stressed, and vulnerable.

Very generally, most farmers classified as "vulnerable" are probably in financial trouble now, while most of those classified as "stressed" are probably headed for such trouble over the next few years unless their returns improve.

The present returns of those classified in "fair" financial position also appear inadequate to sustain their equity or to service fully their debt over the longer term, but the possibility of default appears to be fairly remote.

As shown in the upper panel of table 3, the higher the operator's debt/asset ratio, the less likely that he was considered to be in good financial position. Even among the heavily indebted operators, however, a substantial proportion was operating profitably enough to stay out of the stressed and vulnerable classes.

The right-hand column in the upper panel of the table shows that 70 percent of commercial farm operators were classified in good financial position. The middle panel indicates that these farmers owned 65 percent of the operator-owned assets of commercial farmers, and the bottom panel indicates that they owed 51 percent of the total debt of about $100 billion reported by these commercial farmers.

At the other pole of financial position, 10 percent of all commercial farmers were classified as vulnerable. This group owned 10 percent of the operator-owned assets of commercial farmers. and owed 23 percent of the total debt of these farmers.

Table 4 shows how debt to each of three major institutional sources—banks, the Farm Credit System, and the Farmers Home Administration—was distributed by financial position of the borrower.

Bank loans were in slightly weaker hands than borrowings from the Farm Credit System, while, as expected, the Farmers Home Administration had the highest proportion of loans to vulnerable farmers.

Operators classified as vulnerable owed 25 percent of the total debt of $27 billion that commercial operators reported owing to banks, compared with 20 percent of the total debt of $36 billion that commercial operators reported owing to the Farm Credit System.

Delinquency rates on farm loans at banks have been trending upward, as shown in chart 2. On June 30, past due and nonperforming farm production loans at all banks, at 9 percent of such loans outstanding, were down seasonally from the annual March peak, but up substantially from 6.6 percent a year earlier.

The middle panel of the chart indicates that much of the upward trend has consisted of increases in the amount of farm loans in nonaccrual status, which, at all banks in June, amounted to 5.2 percent of farm production loans.

This increase occurred in spite of the rising trend in farm loan chargeoffs, shown in the lower panel. In the first half of 1985, farm loan chargeoffs were running at about double last year's pace, which, for 1984 as a whole, saw chargeoffs equal to about 2.2 percent of farm loans outstanding.

With farm loan delinquency and chargeoff rates rising, total loan experience has been deteriorating at banks that are heavily involved in farm lending.

Chart 3 shows experience with both total loans and, when available, farm loans at the Nation's 5,000 agricultural banks—those banks at which the ratio of farm loans to total loans now exceeds 17 percent.

It is evident that the lower delinquency rates on nonfarm loans at these banks have been helping to mitigate the adverse trend in the quality of their farm loans.

In particular, recent nonaccrual and chargeoff rates have been much higher on the farm portion of their loan portfolio. Thus, even the limited diversification of loans at agricultural banks has helped their financial condition.

At a majority of agricultural banks, loan delinquency and chargeoff rates are below the average levels shown in the preceding charts, as these averages were affected by very high rates at a small number of banks.

In table 12, the upper panel shows that most agricultural banks still have relatively low levels of nonperforming loans.

In similar fashion, the lower panel indicates that a majority of agricultural banks charged off relatively few loans in the first half of this year. But a substantial and rising minority experienced relatively large losses that will exert a significant impact on their 1985 earnings.

Thus, more agricultural banks have been moving into vulnerable positions such as those illustrated in the two upper panels of chart 4. Many of the agricultural banks that have failed were earlier found among the banks at which delinquent loans exceeded total capital.

The generally upward trend in the number of agricultural banks in that potentially vulnerable position suggests that failures of agricultural banks may continue at recent higher levels shown in the last panel of the chart.

Mr. Chairman, that concludes my statement.

[The prepared statement of Mr. Melichar follows:]

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Farm Financial Experience and Agricultural Banking Experience

Statement by

Emanuel Melichar

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Board of Governors of the Federal Reserve System

before the

Subcommittee on Economic Stabilization
of the
Committee on Banking, Finance, and Urban Affairs

U.S. House of Representatives

October 23, 1985

Farm Financial Experience and Agricultural Banking Experience

Farm sector financial experience

Severe financial problems have been concentrated among those farmers who were highly leveraged as the boom of the 1970s ended, usually because they had expanded their operations. However, many highly leveraged farmers are not in financial trouble, because they are operating profitably enough to service their debt, as will be shown by a new analysis of the financial position of commercial farm operators that I will present in the next section of this report. First, however, I will review briefly the aggregate farm sector experience, which shows how present conditions evolved and provides initial insights into the considerable diversity of financial experience among individual farmers.

In constant dollars, as shown on line 3 of Table 1, cash flow before interest payments so far in the 1980s, while down from boom peaks, has remained above the pre-boom (1970-71) level; in contrast, cash flow after interest (line 5) has been significantly lower. In 1984, cash flow was little changed from the average level experienced so far in this decade.

Before interest payments, net income from assets (line 9) in the 1980s has remained above the pre-boom level; after interest payments, net income from equity (line 11) has been negative. In 1984, net income was boosted somewhat by PIK payments distributed early in the year.

As farm land prices reacted to diminished prospects for income growth and higher returns on alternative investments, sizable real capital losses have reversed part of the large capital gains of the 1970s (line 12). By early 1985, agricultural equity, in constant dollars, was reduced to only two-thirds of its level at the beginning of the decade (line 16).

Table 1

Farm cash flow, income, and balance sheet data, selected periods
(Data excluding farm households)

	Item		Pre-boom 1970-71	Boom I 1972-75	Recession I 1976-77	Boom II 1978-79	Recession II 1980-84	Addendum 1984
	Derivation of cash flow (annual average, billions of 1984 dollars)							
1		Gross income	134	173	162	184	163	162
2	Less:	Operating expenses	76	90	96	104	95	90
3	Equals:	Cash flow before interest	58	83	66	80	67	72
4	Less:	Interest	8	10	12	16	21	22
5	Equals:	Cash flow after interest	50	74	53	64	46	50
	Derivation of net income and total return (annual average, billions of 1984 dollars)							
6		Cash flow before interest	58	83	66	80	67	72
7	Less:	Depreciation	14	17	20	22	21	19
8	Less:	Imputed return to operators' labor and management	31	30	29	29	27	26
9	Equals:	Income from assets	13	37	16	29	19	26
10	Less:	Interest	8	10	12	16	21	22
11	Equals:	Income from equity	5	27	4	14	-2	5
12	Plus:	Real capital gain	14	62	76	90	-54	-116
13	Equals:	Total real return from equity	19	89	79	104	-57	-112
	Balance sheet (end of period, billions of 1984 dollars)							
14		Assets	683	880	1017	1191	853	853
15	Less:	Debt	124	146	177	201	196	196
16	Equals:	Equity	559	734	840	991	656	656
	Rates (percent)							
17	Income return on assets		1.9	4.7	1.7	2.6	1.8	2.9
18	Real capital gain on assets		1.4	6.7	7.0	6.7	-6.1	-13.4
19	Total real return on assets		3.4	11.3	8.7	9.3	-4.3	-10.6
20	Interest paid		6.6	7.1	7.7	8.3	10.4	10.7
21	Real rate of interest		2.5	.7	2.8	.3	5.1	7.6
22	Total real return on equity		3.5	13.5	9.9	11.2	-6.6	-15.7

Data are from Agricultural Finance Databook, Statistical Release E.15, Board of Governors of the Federal Reserve System, July 1985, Tables 101, 112, and 122.

The key aggregate returns derived in Table 1 are shown in Chart 1. In addition to providing an overview of financial experience, these sector totals and averages reveal, as I will discuss, the roots of some of the diversity in financial experience of farmers.

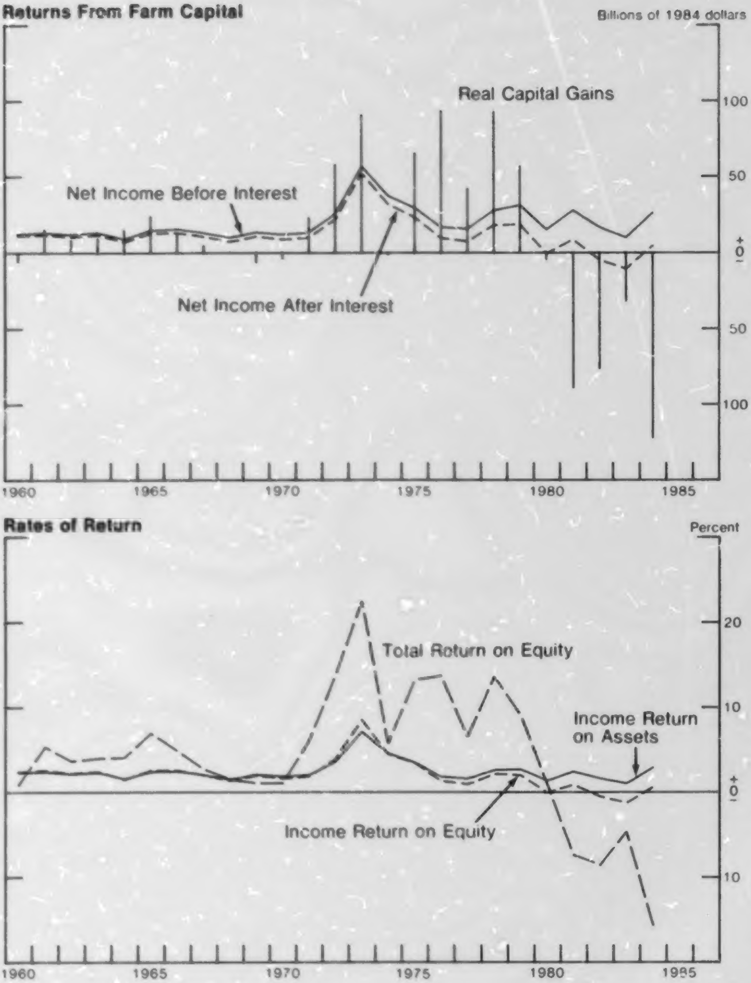
Three key observations can be made. First, although net income before interest payments (solid line in upper panel of chart, from line 9 of Table 1) has fluctuated considerably in recent years, its general level has not changed much since the beginning of this decade. This implies that farmers with little or no debt generally have seen their income maintained. However, as shown by the solid line in the lower panel, their average rate of return has been relatively low.

Second, net income after interest payments (dashed line in the upper panel, from line 11 of Table 1) has been averaging near zero in the 1980s, which implies that farmers with average profitability and average debt have been just able to meet their interest charges from current earnings, whereas those with average profitability but heavier debt have seen their earnings fail to cover their debt service.

Third, income in the 1980s has fallen far short of the expectations that were capitalized into land prices during the preceding decade. Consequently, the huge real capital gains experienced in the 1970s--indicated by the vertical bars in the upper panel (from line 12 of Table 1)--have given way to huge capital losses. Thus in the lower panel, the rate of total return--which includes both income and capital gains--has remained negative since 1980. But the swing in wealth has been mainly experienced by owner-operators of extensive acreage, rather than by tenant operators or by farmers whose operations use relatively little land.

Chart 1

Farm Sector Returns



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Financial position of individual farmers

While presenting a generally deteriorating picture, the aggregate data reveal some strengths as well as weaknesses. But they do not address two important questions: What proportion of farmers is in financial trouble, and how much of the debt does this group owe?

The foregoing review of aggregate relationships has indicated, however, that several income and balance sheet measures should be considered jointly in assessing the financial position of individual farmers. The USDA's newly improved annual Farm Costs and Returns Survey is the only national database that provides the individual data on income, expenses, assets, and debt required for such an analysis. In a cooperative effort with the Economic Research Service, USDA, we cross-classified these 1984 data for "commercial" farmers--those with sales of $40,000 or more in 1984--by return on assets, return on equity, amount of equity, and debt/asset ratio. Then, using this tabulation in conjunction with the criteria shown in Table 2, the farmers were grouped into four financial positions--good, fair, stressed, and vulnerable. To be considered in "good" financial position, a farmer had to have a favorable combination of returns and equity cushion: with relatively heavy debt, very high returns that appeared adequate to service it; or, with little or no debt, returns that were positive. At the other extreme, a farmer with a highly adverse combination of returns and equity cushion was classified as "vulnerable."

Very generally, most farmers classified as "vulnerable" are probably in financial trouble now, while most of those classified as "stressed" are probably headed for such trouble over the next few years unless their returns improve. The present returns of those classified in "fair" financial position also appear inadequate to sustain their equity

Table 2

Criteria for classification of commercial farm operators by financial position

Financial position was determined by joint consideration of four indicators: return on assets, return on equity, amount of equity, and debt/asset ratio.

Return on assets is net cash operating income (before interest payments) as a percentage of owned assets.
Return on equity is net cash operating income (after interest payments) as a percentage of equity (owned assets minus debt).
Equity is owned assets minus debt.
Debt/asset ratio is debt as a percentage of owned assets.

If debt/asset ratio is	and if return on assets is	and if return on equity is	then financial position is
Operators with equity under $50,000:			
Under 40	Above 0	na	Good
40 to 70	Above 5	na	Good
Over 70	Above 15	na	Good
Under 40	-5 to 0	na	Fair
40 to 70	0 to 5	na	Fair
Over 70	5 to 15	na	Fair
Under 40	-15 to -5	na	Stressed
40 to 70	-5 to 0	na	Stressed
Over 70	0 to 5	na	Stressed
Under 40	Under -15	na	Vulnerable
40 to 70	Under - 5	na	Vulnerable
Over 70	Under 0	na	Vulnerable
Operators with equity above $50,000:			
Under 40	Above 0	Above 0	Good
40 to 70	Above 5	Above 5	Good
Over 70	Above 15	Above 15	Good
If not already classified as good, then:			
Under 10	Above -15	Above -15	Fair
10 to 40	Above -5	Above -5	Fair
40 to 70	Above 0	Above 0	Fair
Over 70	Above 5	Above 5	Fair
If not already classified as good or fair, then:			
Under 10	na	na	Stressed
10 to 40	Above -15	Above -15	Stressed
40 to 70	Above -5	Above -5	Stressed
Over 70	Above 0	Above 0	Stressed
If not already classified as good, fair, or stressed, then:			Vulnerable

na Not applied.

or to service fully their debt over the longer term, but the possibility of default appears to be fairly remote.

As shown in the upper panel of Table 3, the higher the operator's debt/asset ratio, the less likely that he was considered to be in good financial position. Even among the heavily indebted operators, however, a substantial proportion were operating profitably enough to stay out of the stressed and vulnerable classes.

The right-hand column in the upper panel of the table shows that 70 percent of commercial farm operators were classified in good financial position. The middle panel indicates that these farmers owned 65 percent of the operator-owned assets of commercial farmers, and the bottom panel indicates that they owed 51 percent of the debt of these farmers.

At the other pole of financial position, 10 percent of all commercial farmers were classified as vulnerable. This group owned 10 percent of the operator-owned assets of commercial farmers, and owed 23 percent of the total debt of these farmers. Note that the latter percentage applies to the total farm debt of about $100 billion reported by commercial operators in the survey, rather than to the larger debt owed by the farm sector (which includes some nonfarm debt of operators as well as the farm debt of farm landlords and the debt of operators of noncommercial farms).

Table 3

Distribution of commercial farm operators and their assets and debt, by relative debt and financial position
January 1985

Financial position	Debt/Asset ratio (percent)				Percentage of total
	Under 10	10 to 40	40 to 70	Over 70	
	Percentage distribution of operators				Operators
Good...........	29	26	11	5	70
Fair...........	5	4	2	2	13
Stressed.......	1	3	2	1	7
Vulnerable.....	*	2	5	4	10
	Percentage distribution of assets				Assets
Good...........	29	26	8	2	65
Fair...........	9	5	2	2	18
Stressed.......	1	4	2	1	7
Vulnerable.....	*	2	5	3	10
	Percentage distribution of debt				Debt
Good...........	2	23	16	9	51
Fair...........	1	5	4	6	16
Stressed.......	*	4	4	3	10
Vulnerable.....	*	2	11	11	23

* Less than 0.5 percent.

Data for 634,000 "commercial" farms with sales of $40,000 or more in 1984, from the 1984 Farm Costs and Returns Survey, ERS, USDA. Classifications by financial position were specified by the author, as shown in Table 2.

Lender debt by financial position of their farm borrowers

The enhanced USDA survey also asked farmers to indicate their sources of debt. Table 4 shows how debt to each of three major institutional sources--banks, the Farm Credit System, and the Farmers Home Administration--was distributed by financial position of the borrower. Bank loans were in slightly weaker hands than borrowings from the Farm Credit System, while, as expected, the Farmers Home Administration had the highest proportion of loans to vulnerable farmers. Operators classified as vulnerable owed 25 percent of the debt held by banks, compared with 20 percent of the debt held by the Farm Credit System.

Table 4

Percentage distribution of commercial farm operators and their assets and debt, by financial position January 1985

Financial position	Operators	Assets	Total debt	Debt owed to—		
				Banks	Farm Credit System	Farmers Home Adm.
Good.........	70	65	51	47	53	39
Fair..........	13	18	16	15	15	18
Stressed.....	7	7	10	13	12	12
Vulnerable...	10	10	23	25	20	31
Total.....	100	100	100	100	100	100

Data for 634,000 "commercial" farms with sales of $40,000 or more in 1984, from the 1984 Farm Costs and Returns Survey, ERS, USDA. Classifications by financial position were specified by the author, as shown in Table 2.

Trends in farm debt

Since 1980, when a large gap opened between farm loan interest rates and the typical yield produced by farm assets, indebted farmers have had a strong incentive to reduce debt, but for many this adjustment was frustrated by adverse income and land price developments. Total farm debt finally peaked in the summer of 1983, after having risen every year since 1945. The decline during the past two years totaled $4.4 billion, or 2.0 percent.

As shown in Table 5, the largest declines occurred at the Commodity Credit Corporation (as it returned grain to farmers during the PIK program) and at production credit associations. These declines were partially offset by expansion at the Farmers Home Administration and commercial banks. Loan growth at the Farmers Home Administration had slowed markedly in 1982 as emergency lending programs initiated by previous administrations expired, but picked up as lending and forbearance policies were liberalized in 1984. Bank lending was relatively strong from 1982 through the spring of 1984 as farm loan interest rates at banks became highly competitive with those charged by production credit associations, but that period ended with an unusually large paydown, 4.5 percent, of outstanding farm production loans at banks during the fourth quarter of 1984.

Table 5

Annual percentage change in farm debt outstanding

Type of debt and lender group	1980	1981	1982	1983	1984	Amount outstanding, billions of dollars, 12/31/84
Total debt....................	9.8	10.9	7.5	-.5	-1.5	213
Banks......................	1.7	2.5	7.9	8.5	3.2	50
Farm Credit System.........	16.7	16.3	4.7	-.2	-1.6	68
Life insurance companies...	6.3	1.1	-2.1	-.7	-2.1	12
Farmers Home Adm...........	21.0	19.1	2.8	.5	7.0	26
Commodity Credit Corp......	-1.8	60.9	92.6	-30.0	-17.7	9
Individuals and others.....	7.7	5.5	1.9	-.5	-6.2	48
Real estate debt..............	11.9	10.5	4.0	2.2	-.8	112
Banks......................	1.4	-4.1	.6	10.4	9.2	10
Federal Land Banks.........	21.3	21.1	8.8	2.3	.5	49
Life insurance companies...	6.3	1.1	-2.1	-.7	-2.1	12
Farmers Home Adm...........	8.5	13.3	3.9	2.7	7.3	10
Individuals and others.....	8.2	5.3	.7	1.0	-7.5	30
Non-real-estate debt..........	7.6	11.3	11.3	-3.4	-2.2	101
Banks......................	1.7	4.4	9.7	8.0	1.8	40
Production credit assns....	8.9	7.5	-3.4	-5.8	-7.2	18
Farmers Home Adm...........	30.9	22.9	2.1	-.8	6.9	16
Commodity Credit Corp......	-1.8	60.9	92.6	-30.0	-17.7	9
Individuals and others.....	6.7	6.0	4.0	-3.0	-3.9	18

Data are from Agricultural Finance Databook, Statistical Release E.15, Board of Governors of the Federal Reserve System, July 1985, Tables 541 and 551.

Recent changes in farm debt

Farm production loans at banks rose by 4.6 percent during the second quarter of 1985, a seasonal increase on the weak side of the normal range. This increase, however, contrasts sharply with no rise at all in outstanding loans at production credit associations (Table 6). But lending by the Farmers Home Administration (FmHA) rose sharply, reflecting the administration's decision to accommodate most loan demand from borrowers that could qualify under rather liberal terms. In the new fiscal year, in anticipation of continued high loan demand, the FmHA has implemented new arrangements designed to allow more of the demands to be met expeditiously through guarantees of loans made by banks and PCAs. Loan volume at the Commodity Credit Corporation (CCC) fell seasonally during the second quarter, but is now rising rapidly as farmers obtain price support loans for relatively high proportions of their large crops. In earlier years during which farmers made large use of CCC loans, they reduced their outstanding loans at banks and PCAs by more than the average seasonal decline.

Table 6

Change in farm debt outstanding at major institutional farm lender groups

Type of debt and lender group	Percentage change		Billions of dollars		Addendum: Amount outstanding, billions of dollars, 6/30/85
	Second quarter 1985	Year ended 6/30/85	Second quarter 1985	Year ended 6/30/85	
Total	1.0	-.5	1.6	-.8	166.2
Banks	4.3	-1.2	2.1	-.6	50.7
Farm Credit System	-1.5	-6.2	-1.0	-4.4	65.5
Life insurance companies	-.4	-3.6	.0	-.5	12.1
Farmers Home Adm	7.6	9.0	2.1	2.4	29.2
Commodity Credit Corp	-14.7	33.3	-1.5	2.2	8.7
Real estate debt	-.6	-.6	-.5	-.5	81.4
Banks	3.1	6.3	.3	.6	10.6
Federal Land Banks	-2.0	-2.5	-1.0	-1.3	48.0
Life insurance companies	-.4	-3.6	.0	-.5	12.1
Farmers Home Adm	1.8	5.8	.2	.6	10.7
Non-real-estate debt	2.6	-.4	2.1	-.4	84.8
Banks	4.6	-3.0	1.8	-1.2	40.1
Production credit assns	.1	-15.0	.0	-3.0	16.7
FICBs*	-4.6	-17.2	.0	-.2	.7
Farmers Home Adm	11.3	10.9	1.9	1.8	18.5
Commodity Credit Corp	-14.7	33.3	-1.5	2.2	8.7

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* Federal Intermediate Credit Bank discounts for farm financing institutions other than production credit associations (mainly agricultural credit corporations formed by commercial banks).

Data are from Agricultural Finance Databook, Statistical Release E.15, Board of Governors of the Federal Reserve System, July 1985, Tables 542 and 552, as updated for this report. As described on page 23 of the Databook, for some lender groups the level of these quarterly series differs from the level of the corresponding annual series shown in Table 5.

Farm loan interest rates at commercial banks

The average interest rate on farm production loans made at banks fell to 12.3 percent in the Federal Reserve System's August survey, down about 2.5 percentage points from the most recent peak reached a year earlier (Table 7). The decline was sharper at large banks at which farm loan rates tend to follow more closely changes in the national prime rate. At smaller banks, where farm loan rates appear to reflect changes in the average internal cost of funds, rates fell about 2 percentage points and in August still averaged nearly 13 percent. In addition to the lag resulting from the tendency toward average-cost pricing, farm loan rates are probably being affected by the desire to cover increased nonperforming loans and charge-offs.

Table 7

Average effective interest rate on farm loans made at commercial banks
(percent)

Period	All banks	Large banks	Other banks
Annual			
1977..........	8.8	8.5	9.0
1978..........	9.6	10.2	9.4
1979..........	11.9	13.6	11.4
1980..........	15.2	16.2	15.0
1981..........	18.5	19.8	18.1
1982..........	16.7	16.1	17.0
1983..........	13.5	12.1	14.1
1984..........	14.1	13.1	14.4
Quarterly			
1983-Q1.......	13.8	12.5	14.1
-Q2.......	13.2	12.0	13.9
-Q3.......	13.6	12.2	14.1
-Q4.......	13.6	11.8	14.2
1984-Q1.......	13.5	12.2	14.1
-Q2.......	14.2	13.3	14.5
-Q3.......	14.8	14.4	14.9
-Q4.......	14.2	13.4	14.4
1985-Q1.......	13.2	11.7	13.8
-Q2.......	13.0	11.5	13.6
-Q3.......	12.3	10.6	12.9

Effective rates shown are estimates from the Federal Reserve survey of terms of bank lending to farmers.

In recent quarters, most "large banks" (survey strata 1 to 3) had over $500 million in total assets, and most "other banks" (survey strata 4 to 6) had total assets below $500 million.

Data are from Agricultural Finance Databook, Statistical Release E.15, Board of Governors of the Federal Reserve System, July 1985, Table 625, as updated for this report.

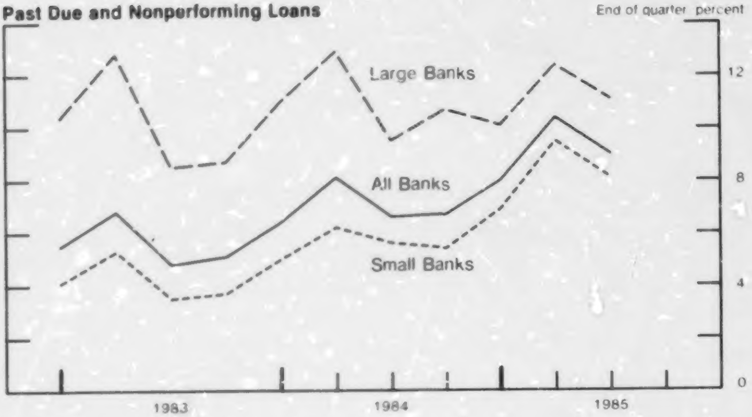
Farm loan delinquencies and charge-offs at all commercial banks

Delinquency rates on farm loans at banks have been trending upward, as shown in Chart 2. On June 30, past due and nonperforming farm production loans at all banks, at 9.0 percent of such loans outstanding, were down seasonally from the annual March peak but up substantially from 6.6 percent a year earlier. The middle panel of the chart indicates that much of the upward trend has consisted of increases in the amount of farm loans in nonaccrual status, which, at all banks, in June amounted to 5.2 percent of farm production loans. This increase occurred in spite of the rising trend in farm loan charge-offs, shown in the lower panel. In the first half of 1985, farm loan charge-offs were running at about double last year's pace which, for 1984 as a whole, saw charge-offs equal to about 2.2 percent of farm loans outstanding.

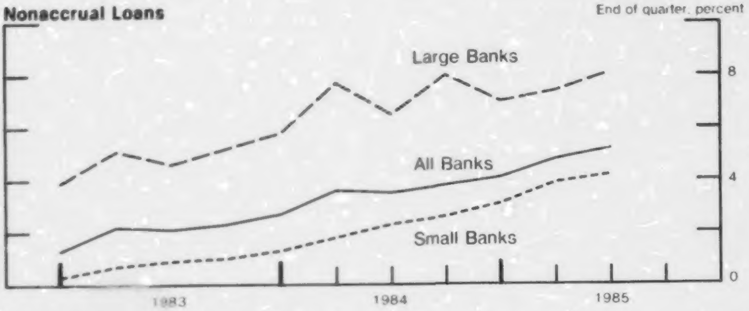
Chart 2

Delinquency and Charge-off Rates on Farm Production Loans
Insured Commercial Banks

Past Due and Nonperforming Loans



Nonaccrual Loans



Net Charge-offs in Quarter

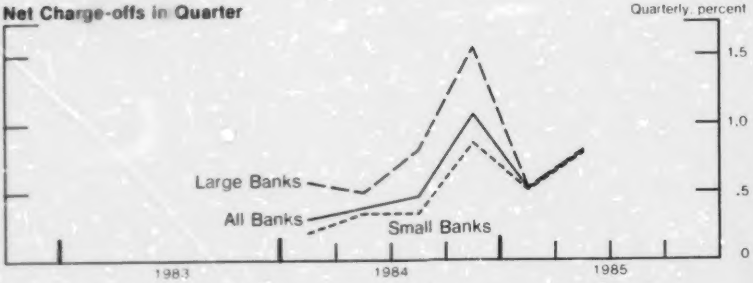


Table 8

Estimated delinquent farm production loans
Insured commercial banks
June 30

Class of delinquent loans	1983	1984	1985
	Billions of dollars		
Total	1.9	2.7	3.6
Past due 30 to 89 days and still accruing	.5	.6	.7
Nonperforming	1.4	2.1	2.9
Past due 90 days or more and still accruing	.5	.6	.7
Nonaccrual	.8	1.4	2.1
Renegotiated	*	.1	.2
	As percentage of outstanding farm production loans		
Total	4.8	6.6	9.0
Past due 30 to 89 days and still accruing	1.3	1.5	1.7
Nonperforming	3.5	5.1	7.3
Past due 90 days or more and still accruing	1.3	1.5	1.7
Nonaccrual	2.1	3.5	5.2
Renegotiated	.1	.1	.4
Addendum: Nonaccrual loans at--			
Large banks**	4.6	6.5	8.1
Other banks	.9	2.3	4.2

* Less than $0.05 billion.

** Large banks have total assets of $300 million or more.

Data are estimates of national totals for farm non-real-estate loans. For June 30, 1985, estimates are based on reports from banks that hold about 92 percent of such loans. Earlier, only large banks that hold about one-fourth of such loans reported nonaccrual and renegotiated farm loans; for other banks, estimates of delinquent farm loans are based on study of delinquent total loans at these banks.

Table 9

Net charge-offs of farm production loans
Insured commercial banks

Period	Estimated amount, millions of dollars	As percentage of farm loans outstanding at end of period
Annual		
1984..................	900	2.2
Quarterly		
1984-Q1...............	120	.3
-Q2...............	160	.4
-Q3...............	195	.5
-Q4..............	425	1.0
1985-Q1...............	200	.5
-Q2...............	320	.8

Data are estimates of national charge-offs of farm non-real-estate loans, based on reports from banks that hold about 92 percent of the outstanding national volume of such loans. Additional uncertainty of the estimates arises because small banks report only charge-offs of "agricultural" loans as defined by each bank for its internal purposes. Banks first reported these data on the March 1984 Report of Income.

Total loan delinquency and charge-off rates at agricultural banks

With farm loan delinquency and charge-off rates rising, total loan experience has been deteriorating at banks that are heavily involved in farm lending. Chart 3 shows experience with both total loans and, when available, farm loans at the nation's 5,000 agricultural banks--those banks at which the ratio of farm loans to total loans now exceeds 17 percent. It is evident that the lower delinquency rates on nonfarm loans at these banks have been helping to mitigate the adverse trend in the quality of their farm loans. In particular, recent nonaccrual and charge-off rates have been much higher on the farm portion of their loan portfolio. Thus even the limited diversification of loans at agricultural banks has helped their financial condition.

The quality of loans at agricultural banks has been deteriorating most rapidly in the Great Plains and western Corn Belt. In Tables 10 and 11, data are shown for agricultural banks in Iowa as well as nationally to illustrate the more adverse experience in this region.

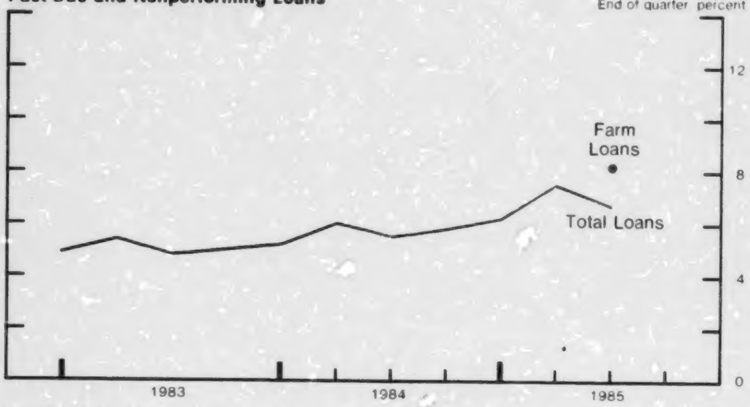
At Iowa agricultural banks, as shown in Table 10, delinquency rates on total loans have risen to levels somewhat above those at all agricultural banks nationally. A year earlier, the Iowa delinquency rates had been about equal to national averages at agricultural banks, and two years earlier they had been slightly lower.

At all agricultural banks, net charge-offs of all loans in the first half of 1985 averaged 0.72 percent of outstandings, compared with 0.41 percent in the first half of 1984 (Table 11). In five states (Colorado, Iowa, Missouri, Nebraska, and Oregon) first-half charge-offs exceeded 1 percent of outstanding loans.

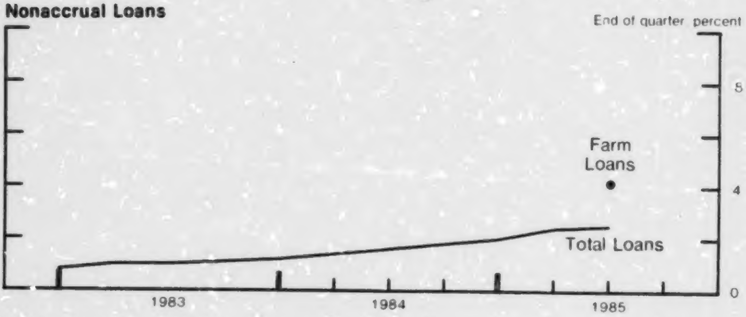
Chart 3

Delinquency and Charge-off Rates on Loans at Agricultural Banks

Past Due and Nonperforming Loans



Nonaccrual Loans



Net Charge-offs in Quarter

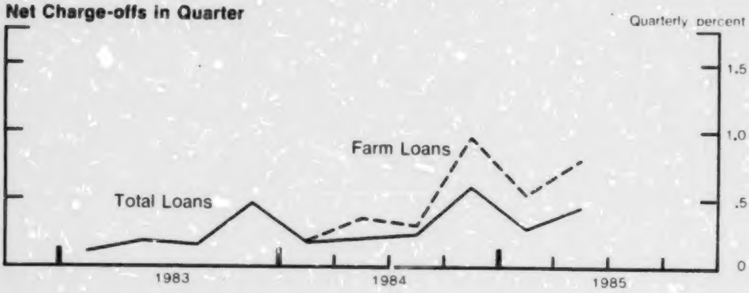


Table 10

Delinquent loans as a percentage of total loans outstanding
Agricultural banks
June 30

Type of delinquency	1983	1984	1985
		United States	
Total	4.8	5.5	6.7
Past due 30 to 89 days and still accruing	2.0	2.1	2.2
Nonperforming	2.9	3.4	4.4
Past due 90 days or more and still accruing	1.6	1.6	1.6
Nonaccrual	1.0	1.6	2.5
Renegotiated	.2	.2	.3
		Iowa	
Total	4.3	5.4	7.2
Past due 30 to 89 days and still accruing	1.5	1.7	1.9
Nonperforming	2.8	3.6	5.3
Past due 90 days or more and still accruing	1.6	1.7	1.8
Nonaccrual	1.0	1.7	3.1
Renegotiated	.2	.2	.5

Agricultural banks are insured commercial banks at which the ratio of farm loans to total loans is above the unweighted average of such ratios at all insured commercial banks (currently about 17 percent). The farm loan ratio at agricultural banks now averages about 37 percent, and these banks hold about 60 percent of all farm loans in the banking system.

Table 11

Net charge-offs as a percentage of total loans outstanding at end of period
Agricultural banks

Area and year	First half	Full year
United States		
1980	.07	.32
1981	.09	.43
1982	.15	.69
1983	.29	.93
1984	.41	1.22
1985	.72	
Iowa		
1980		.31
1981		.34
1982		.67
1983		.92
1984		1.71
1985	1.31	

See note to Table 10.

Distribution of agricultural banks by delinquency and charge-off rates

At a majority of agricultural banks, loan delinquency and charge-off rates are below the average levels shown in the preceding section, as these averages were affected by very high rates at a small number of banks. In Table 12, the upper panel shows that most agricultural banks still have relatively low levels of nonperforming loans. However, the proportion with a very high level of such loans is rising.

In similar fashion, the lower panel indicates that a majority of agricultural banks charged off relatively few loans in the first half of this year. But a substantial and rising minority experienced relatively large losses that will exert a significant negative impact on their 1985 earnings. About one-fifth of all agricultural banks charged off over 1 percent of total loans during the first half of 1985, about double the proportion that had experienced this level of charge-offs during the first half of the preceding year.

Table 12

A. Distribution of agricultural banks by relative nonperforming loans

Nonperforming loans as a percentage of total loans	Percentage distribution, June 30			Number of banks, June 1985
	1983	1984	1985	
Under 2.0...............	53.7	46.0	37.2	1,845
2.0 to 4.9..............	31.7	33.2	32.7	1,624
5.0 to 9.9..............	11.9	16.3	21.2	1,053
10.0 to 14.9............	1.9	3.2	6.1	304
15.0 to 19.9............	.5	.7	1.6	81
20.0 and over...........	.2	.5	1.2	58
Total................	100.0	100.0	100.0	4,965

B. Distribution of agricultural banks by relative first-half charge-offs

Net charge-offs as a percentage of total loans, first half of year	Percentage distribution			Number of banks, first half, 1985
	1983	1984	1985	
Under 0.10................	60.9	55.9	41.7	2,070
0.10 to 0.49..............	23.6	23.8	24.4	1,211
0.50 to 0.99..............	8.3	9.6	13.5	670
1.00 to 2.49..............	5.4	7.4	13.6	677
2.50 to 4.99..............	1.3	2.4	4.9	243
5.00 and over.............	.5	.9	1.9	94
Total..................	100.0	100.0	100.0	4,965

See note to Table 10.

Agricultural bank failures

More agricultural banks have been moving into vulnerable positions such as those illustrated in the two upper panels of Chart 4. Many of the agricultural banks that have failed were earlier found among the banks at which delinquent loans exceeded total capital. The generally upward trend in the number of agricultural banks in that potentially vulnerable position suggests that failures of agricultural banks may continue at recent higher levels shown in the last panel of the chart.

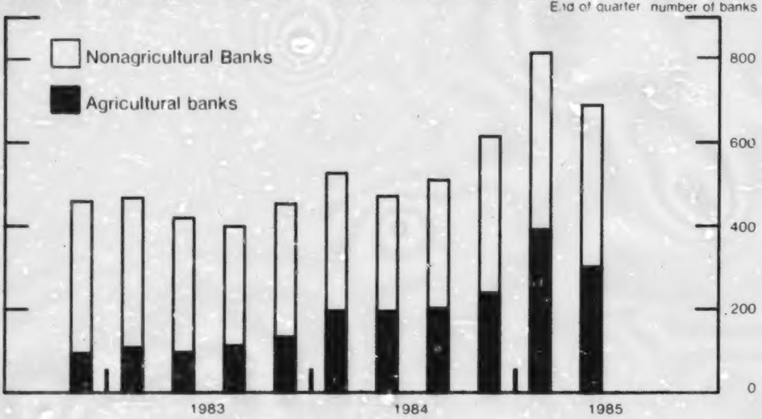
Through October 21, agricultural banks accounted for 57 percent of the failures of insured commercial banks in 1985, and farm loans represented 19 percent of the total loans at all of the failed banks (Table 13). Both proportions are considerably above those in earlier years.

On average, the agricultural banks that have failed have been relatively small. Among those that have failed in 1985, assets at the beginning of the year averaged $22 million, compared with an average of $31 million at all agricultural banks. As shown by the list in Table 14, farm loans exceeded $10 million at only 10 of the banks that have failed this year, and at only two of the banks that have failed since June. Assets at the 54 agricultural banks that have failed totaled about $1.2 billion at the beginning of the year, or only 39 percent of the total assets of about $3.0 billion at all 94 failed commercial banks. Assets at all of the approximately 5,000 agricultural banks total about $150 billion.

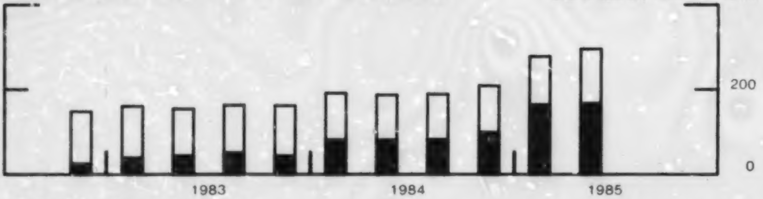
Chart 4

Number of Potentially Vulnerable Banks and Bank Failures

Past Due and Nonperforming Loans Greater Than Primary Capital



Nonperforming Loans Greater Than Primary Capital



Bank Failures in Quarter

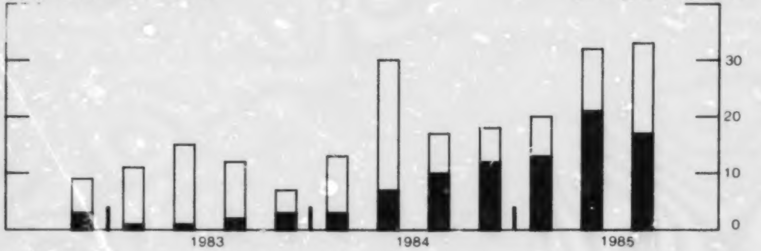


Table 13

Agricultural bank failures and farm loans at failed commercial banks

Period	Number of bank failures			Farm loans at all failed banks	
	Total	Agricultural banks	Agricultural as percentage of total	Millions of dollars	As percentage of total loans
Annual					
1981......	7	1	14	3	4
1982......	35	11	31	49	3
1983......	45	7	16	62	2
1984......	78	32	41	199	10
1985 through October 21:					
	94	54	57	388	19
Quarterly					
1981-Q1...	3	1	33		
-Q2...	1	0	0		
-Q3...	1	0	0		
-Q4...	2	0	0		
1982-Q1...	5	2	40		
-Q2...	10	3	30		
-Q3...	11	3	27		
-Q4...	9	3	33		
1983-Q1...	11	1	9		
-Q2...	15	1	7		
-Q3...	12	2	17		
-Q4...	7	3	43		
1984-Q1...	13	3	23		
-Q2...	30	7	23		
-Q3...	17	10	59		
-Q4...	18	12	67		
1985-Q1...	20	13	65		
-Q2...	32	21	66		
-Q3...	33	17	52		

Loan data are as of the beginning of the year in which the bank failed, except for a few banks which submitted their last report on September 30 of the preceding year.

See note to Table 10.

Table 14

Farm loans at insured commercial banks that failed in 1985, through October 21

Number	Month	State	Millions of dollars, 12-31-84 Total assets	Millions of dollars, 12-31-84 Farm loans	Farm loans as percent of total loans at bank, 12-31-84
1	1	WY	3 *	0 *	0 *
2	1	NE	5 *	2 *	51 *
3	1	OR	9	0	0
4	1	OK	38	2	18
5	1	TX	37	11	55
6	1	IA	22 *	6 *	40 *
7	2	TN	18 *	0 *	0 *
8	2	IA	26	11	65
9	2	CK	17	3	31
10	2	TN	24 *	1 *	4 *
11	2	CA	44	0	0
12	2	CO	18	9	71
13	2	MN	39	16	52
14	2	IA	8	3	63
15	3	FL	39	0	0
16	3	NE	17	4	45
17	3	IA	16	7	67
18	3	IL	5	1	39
19	3	CA	82	15	24
20	3	CO	55	0	0
21	4	OK	3	0	12
22	4	CA	58	0	0
23	4	NE	3	1	60
24	4	OR	18	5	36
25	4	CA	31	0	0
26	4	TX	39	5	17
27	4	CO	17	9	87
28	4	IA	14	6	63
29	4	CA	44	0	0
30	5	KS	68	8	19
31	5	IA	17	9	62
32	5	MO	51	5	13
33	5	IA	38	16	65
34	5	OK	37	9	32
35	5	TX	43	0	0
36	5	TX	57	2	4
37	5	NE	15	10	90
38	5	AR	23	3	16
39	5	OR	128	35	39
40	5	MN	25	9	52
41	5	NE	8	4	62
42	5	NE	4	2	73
43	5	NE	6	3	60
44	6	WY	45	5	17
45	6	KS	9	4	58
46	6	MN	45	15	56
47	6	WI	31	6	31
48	6	KS	4	1	21
49	6	IA	7	2	34
50	6	OK	100	0	0
51	6	NY	141	0	0
52	6	TN	21	1	5
53	7	KS	9	3	46
54	7	AL	45	0	0
55	7	OK	18	0	0
56	7	KS	10	6	68
57	7	TX	18	9	69
58	7	CO	5	0	0
59	7	MO	6	2	37
60	7	KS	23	7	68
61	7	WY	21	0	2
62	7	KS	34	1	5
63	7	KS	26	0	2
64	8	TX	18	0	0
65	8	MN	25	9	54
66	8	ME	13	8	77
67	8	IA	6	3	78
68	8	OK	39	0	0
69	8	IL	15	4	38
70	8	KS	6	2	64
71	8	TX	22	0	0
72	8	AL	87	2	5
73	8	KS	11	3	36
74	8	MO	13	2	35
75	8	MO	8	1	26
76	8	NM	268	0	0
77	9	TN	27	4	25
78	9	CO	11	0	6
79	9	TN	14	0	0
80	9	NM	36	1	3
81	9	WY	31	0	0
82	9	NE	5	3	60
83	9	KS	30	11	54
84	9	TX	29	0	1
85	9	OK	4	1	34
86	10	FL	17	0	0
87	10	OK	24	4	29
88	10	WY	22	1	9
89	10	MO	236	26	16
90	10	OK	13	1	14
91	10	TX	16	2	15
92	10	OK	13	3	33
93	10	NM	5	2	66
94	10	UT	93	2	3
Total........			2975	388	19

* Data as of September 30, 1984.

Chairman LaFalce. Our next witness will be Mr. Boehlje.

I understand he has flight difficulties and will have to leave early to catch a plane.

Mr. Boehlje.

STATEMENT OF MICHAEL BOEHLJE, DEPARTMENT OF AGRICULTURAL AND APPLIED ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. Boehlje. I do have some scheduling problems, but we are working to try to adjust those.

I am not going to spend a lot of time providing additional statistics beyond some of those that have been provided by the previous speakers concerning the financial condition of the agricultural sector. I would note in my written testimony that pages one through three do summarize the results of various studies by various institutions, universities, and the U.S. Department of Agriculture, on the financial condition of the agricultural sector, and the stress that it is now facing.

I just would summarize, I think, all of these studies with a general statement, and that is, that the financial stress problem in agriculture is not as many people, I think, perceive, too many farmers with too much debt. It is a problem with too few farmers with too much debt.

We have a fundamental distribution problem where a lot of debt is being handled by a limited number of farmers and being collateralized by a limited amount of real estate and other assets.

That problem becomes important to the rest of the farm population and to the economy as a whole as those farmers try to resolve their financial stress problems and I will elaborate on that point in a second.

Basically, what we are saying is, that the survey numbers Mr. Melichar provided, or any of the others I have seen, all give the same conclusion, too few farmers with too much debt, which can then result in financial stress for the sector.

Let me move to the implications of this problem in agriculture beyond the farm gate, and here I will pick up on my written testimony on page 4.

The financial stress problems faced by farmers have important implications beyond the farm gate. One of the first is the shortfall in interest and principal payments that the lenders will not receive this year.

Doye and Jolly have estimated that nationwide $2.2 billion of scheduled interest payments and $6.2 billion of principal payments will not be made by farmers because they do not have the cash to service loan obligations.

These shortfalls will have a significant impact on the earnings and the liquidity of those who make loans to farmers. Furthermore, lenders will encounter significantly higher loan loss ratios in the future.

Dr. Melichar has indicated that these ratios have risen dramatically for commercial banks, and similar data indicates equal or more rapid deterioration in the portfolios of the Farm Credit System agencies [PCA's, FLB's].

A recent GAO study of the Farm Credit System has projected its losses at $2.6 billion for the year ending June 30, 1986, and although that is debated by some, other analysts are suggesting that the surprises in the portfolio in the form of undercollateralized loans may add to the losses (Wall Street Journal, October 7, 1985).

The losses that have resulted in 11 bank failures in Iowa since June 30, 1984, continue to plague that industry. A recent survey indicates that for the agricultural banks in Iowa, troubled debt increased by 60 percent since June 30, 1984, and now accounts for more than 32 percent of capital.

Troubled debt is greater than equity capital at 24 banks, and more than 90 banks lost money in the first half of 1985. Nationwide, 363 of the 975 banks on the FDIC's troubled bank list are agricultural banks (Des Moines Sunday Register, October 13, 1985).

Analysis by Reinders indicates that with 3- to 5-percent loss ratios—which some lenders are now encountering—even a very financially sound lender with 20 percent equity can remain in business for only 3 to 4 years. We need to recognize that a lender becomes nonviable before it runs out of capital, and there is a misperception on this issue.

As I view it, lenders have, as equally important resources, qualified personnel to service their agricultural loan portfolio, and a loyal and sound customer base.

What we see happening in some lending institutions at the current time is that they are having a runoff of their loyal, sound customer base, and a runoff of their qualified personnel that may be more severe than the deterioration in their capital position, and we end up with a lending institution that may have an equity base to continue functioning but not a customer or a personnel base to function at a profitable level in the future.

Let me continue on with my written statement.

The agricultural input supply firms have financial problems as well. Ginder indicates that there has been a 400-percent increase in accounts receivable writeoffs, losses, from 1981 to 1984, in a representative sample of cooperative input supply firms in the Central States.

Approximately one-third of the sample firms have debt-to-asset ratios exceeding 70 percent. If bad debts total 1 to 2 percent of sales, 25 percent of these firms will have debt servicing problems, and bad debt of 3 to 4 percent of sales would almost double the number of firms with debt servicing problems.

Currently, these firms have 1 percent of sales in accounts receivable outstanding for 180 days or more—much of which will not be collected—and another 1 percent in accounts receivable of 60 to 180 days. Thus, many agribusiness firms are also financially vulnerable and a relatively small increase in nonpayment on accounts receivable or a loss due to a farmer bankruptcy would threaten their survival.

In summary, the impact of financial stress in agriculture on the U.S. economy might be visualized as a series of waves. The first wave will involve those highly leveraged farmers who cannot service their entire debt load. As these highly leveraged farms attempt to resolve their financial stress through the sale or other disposition of assets, the remaining farm population will incur costs in the form of higher interest rates and reduced land values and thus impaired credit worthiness because of declining collateral. This is the second wave.

The third wave occurs when farmers reduce their purchases of capital items from local suppliers and are not able to pay on open accounts and trade credit extended by input supply firms.

Thus, the local community absorbs part of the loss or cost because of reduced retail sales and economic activity, as well as losses from nonpayment on accounts receivable and bankruptcies.

One of those institutions which will not receive payments from financially stressed farmers is the lending institution. As lending institutions become financially vulnerable, particularly those that access national money markets such as the Farm Credit System, the financial markets begin adding a larger risk premium to interest rates to compensate for the default risk and nonperformance of borrowers.

Interest rates will rise first for agricultural loans, but as the Wharton study suggests, if the loss is large enough the financial markets will require a larger risk premium from all borrowers, nonfarm businesses, governments, and consumers. This is the fourth wave and the mechanism by which losses in agriculture will be transferred to nonfarm businesses, consumers, and the economy at large.

Note that this transfer occurs not through higher food costs, but through higher interest rates. We do not expect to see significant amounts of farm property that will remain idle and not be farmed resulting in food shortages, particularly when we have excess machinery capacity and labor in the agricultural sector to operate that property.

Thus, the public will pay for part of the financial stress in agriculture, either through higher interest rates and larger Government deficits due to the economic slowdown that is a result of higher interest rates, or through increased direct Government expenditures to fund preemptive public sector intervention to reduce the consequences of financial stress in agriculture on the overall economy.

Let me summarize briefly the next section of the written testimony.

What we have tried to do is to identify five adjustments which we think need to occur in the agricultural sector to obtain a financially stable sector. One is lower interest rates; the sector is having a difficult time adjusting to the current high rates, and those rates must come down or we must have continued declines in the resource values in agriculture.

The adjustment will occur one place or the other, either lower rates and if that doesn't occur, then land values have to come down further.

Two, we have to mothball excess capacity. Here we have the fundamental problem of how do we reduce production in this country without giving markets away, as happened in prior times. That is why there is a discussion about changes in farm policy to improve our competitive position and reduce the excess capacity problem at the same time with higher levels of set asides.

Three, lower resource values. It is clear that land values were bid out of line, not out of line with the expectations of the 1970's, but certainly out of line with respect to the realities of the 1980's.

Maybe our biggest fault is we didn't have the foresight to see that things would turn around as quickly as they did, with respect to interest rates, foreign markets, the value of the dollar, and inflation. It is not clear that land values were out of line, in the 1970's, but they are clearly out of line in terms of today's realities.

We have to adjust down those values, how far depends on how far up or down interest rates go. If interest rates go down or stay at stable levels as they are now, land values won't have to go down as far. We are going to get the adjustment one place or the other.

We have to have a reduced indebtedness for the agricultural sector or have a redistribution of that debt. It is clear that agriculture cannot handle the debt load that it has. We have to get rid of it in some fashion, and that occurs fundamentally in three ways; either paid off with income, paid off through the sale of assets or written off. With the limited income prospects of many financially stressed farmers—it leaves to adjustment mechanisms—either the debt has to be gotten rid of by the sale of assets or through the lending community writing it off, and we expect significant write-offs will occur.

We have to restructure the asset ownership in agriculture. It is a painful reality, many farmers have assets they can't afford to own. Either the lender will say, that is OK, we don't expect you to pay anyway, which is unrealistic, and won't occur; or the farmer will have to sell that asset base. We are going to have to have some change in the ownership pattern of assets in many farm businesses.

Those adjustments, it seems to me, have to occur. The question is what kind of speed of adjustment can we handle in the agricultural sector and what kind of public policy might be utilized to, if you will, keep that speed of adjustment from being traumatic and too fast for many farmers.

In my written testimony I have included some material on beneficiaries of any type of public sector assistance program, and I will leave that for your review. I have also included on page 13, some public policy choices.

I introduce these public policy choices, because it is important to recognize that there are some options, and there is going to be discussion, already there is occurring a discussion, if not at the Federal level, clearly at the State level, of public sector intervention options.

I want to comment on one, not to recommend it as an option, but to identify one of the objectives that we might have in terms of any public sector intervention. This starts on page 18, where we talk about the issue of facilitating the changed ownership pattern of assets.

As we have already indicated, there are a number of farmers that own property that they can no longer afford to own and those properties will have to change hands, but as those properties change hands, that puts additional downward pressure on the asset markets unless there are funds available or liquidity on the part of others to acquire that property.

We suggest that there are a number of ways to facilitate changing the ownership pattern of assets. Lending institutions might be encouraged to take title to property in lieu of debt obligations, and lease the property back to the original debtor. A survey in Iowa indicates that one-third of the properties of farmers selling out is being rented back to the original owner.

If this were to happen, other resources such as machinery and equipment would not require liquidation. The lender would be converting a nonperforming asset into one that generates at least some return.

To avoid the problem of lender illiquidity from holding such assets, the Government would likely need to provide funds—perhaps through the Federal Reserve discount window or sale of Government-guaranteed bonds—in the amount of the transferred assets. The lender might be required to remove the assets from its portfolio over a 2- to 4-year period. The original debtor would have first option to buy.

Government programs could also be initiated to hold repossessed land off the market. For example, FmHA is, in some places, already holding foreclosed land off the market for 1 to 3 years.

Private lenders could be assisted in other ways in holding land off the market. Bank regulations typically require that real estate assets taken over by the bank be valued at market first, and then be written down annually to discourage holding of such assets.

The bank loses equity and is encouraged to dump assets. Some States even prohibit ownership of farmland by lenders or corporations, thus forcing repossessed farmland onto the market.

Methods should be considered to enable lenders to have more flexibility in recognizing the losses in their agricultural portfolio. A longer period over which assets are written down to market value—possibly 2 to 5 years—would allow the lender to offset the loss with future earnings rather than impair the capital base of the institution.

Capital certificates provided by the U.S. Government in the amount of losses on agricultural loans that must be amortized over time—5 to 10 years—may also be a useful mechanism for using time and future earnings to blunt the size of the losses on the financial viability of lending institutions. This procedure would involve Government guarantees of the capital structure of the lender rather than part of the loan portfolio.

An alternative approach would be for a State or the Federal Government to charter an entity to acquire nonperforming real estate debt and the assets securing that debt from lenders. Acquisitions would be held off the market, perhaps leased back to the original farmer, or put into a conservation reserve program.

Funding could come from sale of State or federally issued tax exempt bonds.

I will not detail other options at this stage that might be considered. My point here is to note that we do need to use time creatively and future profits creatively in helping blunt the impact of current losses in the agricultural loan portfolio of many lenders.

On page 21 through 23, we talk about some concerns we have about changing attitudes in rural communities. I would again leave that for your perusal.

We are concerned that there are some changes that are occurring in terms of concepts of commitment, willingness to follow through on loan obligations even though there may be the financial resources to do so. We do have some concerns about what that might mean for business relationships in rural communities.

Data from a number of studies indicate that a significant number of farmers are suffering financial stress.

This stress is a result of the many changes in the financial environment for agriculture, and is not simply a result of lower incomes. Other factors that contribute to the financial stress problem of the U.S. agricultural sector are a higher debt load, shorter maturities on debt, reduced liquidity, higher and more volatile interest rates, increased income and collateral risk, limited availability of refinancing alternatives, and asset liquidations.

Government policies of the past have contributed to today's financial stress by encouraging higher land values, more debt utilization, growth in farm size, and higher interest rates.

Given the complex nature of the financial stress problem, a public policy approach that focuses only on one characteristic of that problem will probably be ineffective. Specifically, price and income support programs which have been the major component of agricultural policy in the past may be quite ineffective in solving the current financial stress problem. Such programs do not focus on some of the major dimensions of the stress problem, for example, loan maturities, liquidity, collateral risk, et cetera, and furthermore quite likely will not be targeted to those individuals who have financial stress.

Such programs may in fact compound and contribute to the longer run financial problems in agriculture. A study done recently by a group at Iowa State University suggests that even if we have a significant amount of income support, from government price and income supports for agriculture, there will be significant amounts of farm property that will not cash-flow and will have to be put on the market.

While spiraling farm debt suggests that debt restructuring is the answer to the current financial stress, a restructuring of agricultural assets remains the key to a long-term solution. The results of both firm level and aggregate analyses indicate that asset restructuring through sale-leasebacks is a preferred option to interest rate buydowns or liability restructuring in reducing financial stress for individual farm firms and the industry.

The rearranging of liabilities is not a permanent solution to the current financial stress, because even with more time to repay, many farmers will not be able to service their debt with current or expected interest rates, productivity, and input and commodity prices. However, debt restructuring is an important mechanism for buying time to implement more permanent solutions.

Asset restructuring including liquidation, debt reductions, and equity infusions will be required to improve the chances of long-term survivability of many farm businesses.

One of the key objectives of any public policy to alleviate financial stress should be to protect the resource markets from collapsing. Stabilizing resources values is critical to maintaining the stability of the agricultural production sector and rural communities.

If resource values decline precipitously because of excessive supplies being offered to a market that has no liquidity to absorb them, many farmers who were a "good credit risk" will no longer be so because of declining collateral values.

But using Government intervention to stabilize resource values at levels that are not supportable in the long run can result in very high Government costs, inefficient resource allocation, and higher consumer prices for food products. Such a result is also clearly not desirable.

The agricultural sector has suffered significant wealth losses during recent years. An important public policy concern is how those losses will be shared among the various firms in the private sector—farmers, lenders, input supply firms, landlords, et cetera, and between the public sector and the private sector.

A related concern is how to keep the losses from becoming more severe than they need be. A strategy of doing nothing today could, if the financial condition of agriculture continues to deteroriate, very easily result in irresistible political and economic pressures to implement drastic options later such as a general and extended debt moratorium or significant increases in commodity support prices.

But inappropriate action now may interfere with the longer run adjustments in resource values and utilization that must occur to retain an efficient and financially sound agricultural sector.

[The prepared statement of Mr. Boehlje follows:]

FINANCIAL STRESS IN AGRICULTURE: IMPLICATIONS FOR FARMERS, LENDERS AND CONSUMERS

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FINANCIAL STRESS IN AGRICULTURE:
IMPLICATIONS FOR FARMERS, LENDERS AND CONSUMERS

INTRODUCTION

Many farmers are currently facing severe financial stress resulting in asset liquidations, problems in obtaining credit, and even bankruptcy. An important question in farm analysis is the applicability of traditional policy approaches to the problem of financial stress in agriculture, and the appropriate farm policy in this financially stressful time. This is a particularly relevant question given that the 1983 PIK program was one of the most expensive and largest government transfer programs for agriculture in recent history, and yet many farmers are still facing severe financial problems.

The roots of the financial problems of farmers today can be traced to the environment of the 1970s and the dramatic changes in that environment during the early 1980s. The decade of the 1970s can be characterized by high inflation rates, growing foreign and domestic demand for farm products, very low or negative real rates of interest, and a willingness to substitute asset appreciation for current earnings. Farmers borrowed heavily to purchase capital inputs and farmland and to aggressively expand their operations. Then in the 1980s interest rates rose to unprecedented high levels, foreign and domestic demand for farm commodities declined significantly because of worldwide recession, incomes dropped dramatically, and land values began a steady and relatively steep decline. Those farmers with high debt loads found it difficult to collateralize and service that debt with high interest rates, low incomes, and decreasing land values.

FINANCIAL STRESS IN AGRICULTURE

Melichar [January 1984] was the first to document the financial condition of the agricultural sector; that data will not be repeated in detail here. A key dimension of this documentation is the distribution of debt (Table 1). This distribution indicated that in 1984 approximately 58 percent of the farms in the United States had leverage ratios of 10 percent or less, 24 percent had ratios from 11-40 percent, 11 percent had ratios of 41-70 percent and eight percent had leverage ratios in excess of 70 percent. This highly leveraged category (greater than 70 percent) controlled 31 percent of the debt and eight percent of the assets in U.S. agriculture. With current price, cost, and productivity relationships in agriculture, these highly leveraged farms are unable to make interest payments on their indebtedness, let alone repay any principal. In fact, Melichar's calculations suggest that farms with debt-to-asset ratios exceeding 30 percent will likely encounter some financial stress at current interest rates and rates of return on assets.

Survey data from individual Iowa farms corroborates Melichar's results and implications [Jolly, 1984]. Of the 1,231 farmers surveyed, 31 percent had no real estate or nonreal estate debt and exhibited debt-to-asset ratios averaging 1.8 percent; these farmers are not financially stressed by the current economic conditions in agriculture. In contrast, 40 percent of the farmers have both real estate and non-real estate debt and a debt-to-asset ratio averaging 41.7 percent. Table 2 indicates the distribution of operators, assets, and liabilities for the Iowa sample by debt-to-asset category; the distributional results are very similar to those in Table 1 from Melichar's work. Size classification of the data (Table 3) suggests that financial stress problems are not unique to a particular size firm - firms of all sizes are encountering such stress.

More recent studies corroborate that the financial stress in agriculture is not unique to Iowa. A national survey in January 1985 by Farm Journal and the Food and Agricultural Policy Research Institute indicates that nationwide, 15.4 percent of farmers have debt-to-asset ratios exceeding 70 percent, and 17.9 percent have debt-to-asset ratios of 40-70 percent; these farmers account for 30.8 percent and 34.9 percent of the debt respectively [Farm Journal, March 1985]. For the Central States, the data indicates a more severe problem; 21.0 percent of the farmers have debt-to-asset ratios exceeding 70 percent and 21.5 percent have ratios of 40-70 percent. Comparing these numbers to those obtained for Iowa in 1984 suggests that the financial conditions have deteriorated significantly in just one year.

A recently released USDA study also documents the nationwide characteristics of the problem [USDA, 1985]. That study estimated that as of January 1985, 6.3 percent of family sized farms in the U.S. holding 9.3 percent of the debt are insolvent; 7.4 percent of the farms holding 11.1 percent of the debt have debt-to-asset ratios from 70-100 percent, and 20 percent of the farms holding 25.9 percent of the debt have debt-to-asset ratios of 40-70.

Financial management strategies and enhanced farm and off-farm income can be used to relieve the stress for many farms, but those with higher leverage ratios (for example, 70 percent or greater) will likely not be able to obtain sufficient relief from various financial and farm management strategies to stave off asset liquidation or default. In essence, at least 8-10 percent of U.S. farm assets must find a new owner in the next year or so, or the debt secured by those assets will not be serviced. Even those with debt-to-asset ratios of 40-70 percent will experience declining equity (even if land values stabilize) unless commodity prices rise, interest rates and other input prices fall, or productivity increases. In essence, the financial stress is significant for a subset of the farm population.

The financial stress problems faced by farmers have important implications beyond the farm gate. One of the first is the "shortfall" in interest and principal payments that the lenders will not receive this year. Doye and Jolly have estimated that nationwide $2.2 billion of scheduled interest payments and $6.2 billion of principal payments will not be made by farmers because they do not have the cash to service loan obligations [Doye and Jolly]. These "shortfalls" will have a significant impact on the earnings and the liquidity of those who make loans to farmers. Furthermore, lenders will encounter significantly higher loan loss ratios in the future. Melichar has indicated that these ratios have risen dramatically for commercial banks, and similar data indicates equal or more rapid deterioration in the portfolios of the Farm Credit System Agencies (PCAs, FLBs). A recent

GAO study of the Farm Credit System has projected its losses at $2.6 billion for the year ending June 30, 1986, and some analysts are suggesting that the "surprises" in the portfolio in the form of under-collateralized loans may add to the losses (Wall Street Journal, 10/7/85). The losses that have resulted in 11 bank failures in Iowa since June 30, 1984, continue to plague that industry. A recent survey indicates that for the agricultural banks in Iowa, troubled debt increased by 60 percent since June 30, 1984, and now accounts for more than 32 percent of capital. Troubled debt is greater than equity capital at 24 banks, and more tha 90 banks lost money in the first half of 1985. Nationwide, 363 of the 975 banks on the FDIC's troubled bank list are agricultural banks (Des Moines Sunday Register, October 13, 1985). Analysis by Reinders indicates that with three to five percent loss ratios (which some lenders are now encountering) even a very financially sound lender with 20 percent equity can remain in business for only three to four years [Reinders].

The agricultural input supply firms have financial problems as well. Ginder indicates that there has been a 400 percent increase in accounts receivable write-offs (losses) from 1981 to 1984 in a representative sample of cooperative input supply firms in the Central States [Ginder]. Approximately one-third of the sample firms have debt-to-asset ratios exceeding 70 percent. If bad debts total one to two percent of sales, 25 percent of these firms will have debt servicing problems, and bad debt of three to four percent of sales would almost double the number of firms with debt servicing problems. Currently, these firms have one percent of sales in accounts receivable outstanding for 180 days or more (much of which will not be collected), and another one percent in accounts receivable of 60 to 180 days. Thus, many agribusiness firms are also financially vulnerable and a relatively small increase in non-payment on accounts receivable or a loss due to a farmer bankruptcy would threaten their survival.

The financial problems of farmers and agriculture may be sufficiently large to impact the public at large and the performance of the national economy. This impact will likely not occur through shortages of food and higher food prices, but through the financial markets. Wharton Econometrics has assessed the impact of financial stress in agriculture that results in non-payment of agricultural debt on the financial stability of the lending institutions and financial markets. Their analysis suggests that with a continuation of current farm income conditions and no government assistance to solve the farm financial crisis, loan losses could total as much as 20 to 25 billion dollars, which is approximately 10 percent of the total $212 billion agricultural debt. A write-off of this magnitude would result in higher short-term private interest rates "due to the public perception of substantially higher risk being associated with financial asset holdings." The Wharton study argues that "although agricultural debt is dispersed among many creditors, the impact of large and widespread defaults on commercial banks and the farm credit systems is expected to be sufficient to affect national financial markets." Their study indicates that the result of a write-off of $20 to $25 billion of agricultural debt would be a 75 to 125 basis point increase in short-term interest rates, 175,000 to 275,000 jobs lost, a reduction in total gross national product by $30 to $50 billion, and a $14 to $21 increase in the federal debt. The Wharton study suggests that financial stress faced by agriculture will eventually impact the national economy and the public at large unless preemptive measures are taken to resolve the farm financial crisis.

In summary, the impact of financial stress in agriculture on the U.S. economy might be visualized as a series of waves. The first wave will involve those highly-leveraged farmers who cannot service their entire debt load. As these highly-leveraged farms attempt to resolve their financial stress through the sale or other disposition of assets, the remaining farm population will incur costs in the form of reduced land values and thus impaired credit worthiness because of declining collateral. This is the second wave. The third wave occurs when farmers reduce their purchases of capital items from local suppliers and are not able to pay on open accounts and trade credit extended by input supply firms. Thus, the local community absorbs part of the loss or cost because of reduced retail sales and economic activity, as well as losses from non-payment on accounts receivable and bankruptcies.

One of those institutions which will not receive payments from financially stressed farmers is the lending institution. As lending institutions become financially vulnerable, particularly those that access national money markets such as the Farm Credit System, the financial markets begin adding a larger risk premium to interest rates to compensate for the default risk and non-performance of borrowers. Interest rates will rise first for agricultural loans, but if the loss is large enough, the financial markets will require a larger risk premium from all borrowers - non-farm businesses, governments, and consumers. This is the fourth wave and the mechanism by which losses in agriculture will be transferred to non-farm businesses, consumers, and the economy at large. Note that this transfer occurs not through higher food costs, but through higher interest rates. Thus, the public will pay for part of the financial stress in agriculture, either through higher interest rates and larger government deficits due to the economic slowdown that is a result of higher interest rates, or through increased direct government expenditures to fund preemptive public sector intervention to reduce the consequences of financial stress in agriculture on the overall economy.

SECTOR ADJUSTMENTS TO OBTAIN STABILITY

Five major long-run adjustments appear necessary to obtain a more financially stable agricultural sector. These include:

1. Lower interest rates. Lower interest rates would benefit agriculture in four ways: lower direct costs of borrowing money, a lower valued dollar and increased demand and prices in the export markets, lower inventory carrying charges for holders and purchasers of agricultural commodities

and thus marginally higher prices, and lower interest costs for supply firms and thus marginally reduced prices of purchased inputs. Interest rates, real and nominal, are very high by historical standards. Most analysts agree that reduction in the government deficit would result in lower real and nominal interest rates and a somewhat lower valued dollar. The importance of lower interest rates for agriculture is difficult to overstate; a one percent decline in interest rates on the over $200 billion of U.S. agricultural debt would result in an approximate $2 billion increase in net farm income. Tweeten estimates that lower interest rates resulting from a balanced budget would reduce the value of the dollar in foreign markets by 20 percent, leading to a 10 percent increase in exports within two years and as much as a 20 percent improvement in the longer run.

2. Mothball excess capacity. The U.S. agricultural sector currently has approximately five to ten percent excess production capacity (Tweeten). This contributes significantly to the current low rate of return on farm assets. Yet, the productive capability of some of the agricultural asset base is deteriorating because of excessive soil erosion. Conversion of 20 to 30 million acres of steep, erosive and low yielding grain land to grass or nonuse is one way to eliminate excess production and reduce soil erosion.

3. Lower resource values. In a period of excess capacity, a normal economic response is lower resource earnings and lower asset values. Land values in parts of the U.S. are 35-40 percent below the peak of the early 1980s. Given current prospects for prices, interest rates, and expected

input costs, farm asset values may fall further. The financial stress of farmers further compounds the problem because a major strategy for alleviating financial stress is asset liquidation. Such liquidations increase the supply of land on the market and further contribute to land price declines.

4. *Reduce debt*. The total debt load of agriculture is not evenly distributed. About one-third of the farmers owe approximately two thirds of the debt. For many of these farmers, earning capacity of assets is not sufficient to cover debt service costs with current interest rates and profit margins. This "excessive" debt must either be redistributed or eliminated. Redistribution may occur through debt-financed purchases of assets from those having cash flow problems by financially sound farmers or other investors. A reduction of the industry debt load will occur by repayment of debt with earnings from either on or off-farm sources, by substitution of equity from outside the agricultural sector for farm debt, or by discharge of debt by agricultural lenders. Probably a significant amount of agricultural debt will be discharged or written off over the next three to five years by the public and private lending institutions that service agriculture. This discharge of indebtedness will represent significant costs to lenders in the short run, but it will reduce the sector debt load and improve agriculture's financial condition in the long run.

5. *Restructure asset ownership*. Some farmers with very high debt loads cannot "afford" to own all of their assets, and these assets must find

new owners. This asset restructuring in many cases will accompany the redistribution and restructuring of debt. Lenders will inventory some assets in lieu of the note or mortgage, but these assets will eventually be placed on the market. Accompanying this restructuring of the ownership pattern of assets will be a set of important issues concerning the tenure arrangements in agriculture including the institutional structure and property rights of tenants versus landlords, the advantages and disadvantages of the separation of ownership and operation of real estate, and the volatile issue of outside equity in agriculture.

BENEFICIARIES OF AN ASSISTANCE PROGRAM[1]

From a policy perspective, any proposal should establish general guidelines as to farmers, lenders and others who would reasonably be benefitted by the program intervention and those who realistically could not benefit from the program. The most recent financial survey of farm operators conducted by the USDA delineates three broad groups toward which specific policies might be targeted. This information is summarized in Table 4.

There are farms whose financial condition is so weak that debt and asset restructuring is not effective or feasible. We designate this group as not restructurable. Their most likely option would be to exit agriculture. We identify farmers in this group as those who are technically insolvent as of January 1, 1985, or had a return to equity less than -20 percent in 1984. Farmers in this group are consuming their capital stock so rapidly it is unlikely they can reorganize soon enough to avoid insolvency - particularly with the pressure of continuing declines in asset values.

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[1] Taken from "Alternatives for Public Intervention to Assist in Stabilizing Farm and Ranch Financial Conditions," prepared by Neil E. Harl, Robert W. Jolly and Michael D. Boehlje, Department of Economics, Iowa State University, Ames, Iowa, and Steven E. Zumbach, Partner with Belin, Harris, Helmick, Heartney and Tesdell, Des Moines, Iowa. Unpublished paper, Iowa State University, Ames, Iowa, 1985.

Restructurable farms are those who can reorganize debts and assets and become profitable under economic conditions likely to prevail over the next five to ten years. This group consists of farmers with a return to equity from -20 percent to +5 percent in 1984.

Profitable farms are defined as those who earned more than 5 percent on equity in 1984. This group includes "going concerns" whose financial structure is appropriate for current and expected economic conditions. It also includes possible or recent entrants who have taken advantage of lower asset values and started farming.

The needs of these groups for financial assistance vary. In addition, their needs depend fundamentally on whether or not current economic conditions persist or will change abruptly in a year or two. Farm businesses must adjust to economic conditions characterized by high real interest rates, commodity prices near current levels and continuing variability in input and output prices. Changes in these assumptions would alter the degree but not likely the kind of adjustment required for financial viability.

Nonstructurable firms need to exit quickly without the risk of further declines in the value of assets. Current market conditions will not permit this group to sell out. Delays erode what little equity they have remaining. Furthermore, asset liquidations by this group should be isolated from the market to avoid depressing asset values for all producers.

Restructurable farms need to move toward a viable financial structure quickly. Frequently this involves liquidating land and, in some cases, leasing additional assets. Again, these changes can be accomplished if the liquidity of asset and rental markets can be increased. Increased market liquidity results in a greater and more rapid volume of transactions and less reduction in asset values replacing reduced price response.

Profitable farms, particularly new entrants, need stable asset markets and access to long-term financing. Declining asset values erode the normally low equity of younger or entering farmers. This places them at risk from insolvency. Further, credit rationing by lenders because of insolvency risk may limit efficiency and growth of these nascent businesses.

Deregulation and widespread agricultural loan losses may lead to relatively high and variable interest rates. Beginning farmers particularly need access to long-term financing with predictable and flexible debt service requirements. During the ensuing period of financial adjustment, existing lenders may be hard-pressed to provide financing of this sort.

SHORT TERM PUBLIC POLICIES TO AID TRANSITION

A number of transition policies involving credit or lender adjustments are being discussed to deal with current financial stress of farmers (Brake, Boehlje and Lee; Doye and Jolly). Five of the more frequently discussed policies are debt restructuring, principal forgiveness (write-off), interest buy-down, foreclosure moratoria, and inventorying assets or facilitating changes in asset ownership patterns.

1. Debt restructuring. This refers to rescheduling of loan commitments by refinancing or rewriting short-term or intermediate-term debt to a long-term basis if justified by real estate collateral. Alternatively, each class of loans - short, intermediate and long-term - may be rescheduled over a longer repayment period. The premise of restructuring is that additional time to repay the principal reduces annual obligations.

Debt restructuring can be done voluntarily, and it can be useful for some percentage of farmers in trouble, i.e., those who need marginal help rather than massive help. For borrowers whose short- or intermediate-term debt is a high proportion of total debt, substantial improvement in cash flow may result from restructuring. However, the long-term benefits of restructuring should not be overestimated (Boehlje, Thamodaran and Barkema).

While restructuring is typically done on a voluntary basis by the lender, it may be encouraged by a government guarantee of the loan. FmHA has used this approach of providing a guarantee for 90 percent of the principal if the lender will write down the debt by at least 10 percent (principal or interest rate equivalent) and then restructure the loan so that a cash flow budget shows obligations can be met.

Restructuring farmer debt involves few costs to borrower or lender if the situation is analyzed carefully beforehand. There are no public costs unless loan guarantees are involved. Probably much of the potential voluntary debt restructuring has already occurred, however.

2. Principal forgiveness or write-down. A write-down might recognize that the value of the asset has fallen below the loan amount. Or, a write-down may be negotiated to ease impossible debt service requirements. Whether the write-down will resolve the problem depends on the debt service obligation in relation to income.

A write-down initiated by examiners can create a problem for lenders because it represents a direct loss of equity on the books. The lender might not agree with the examiner's analysis, yet the examiner forces the lender to reduce asset values, in turn eroding lender equity.

A principal buy-down is typically initiated through a public credit policy. An FmHA guarantee, for example, might apply if the lender writes down part of the outstanding principal and restructures payments to ease the debt service burden of the borrower.

While principal forgiveness or buy-down helps farmers in financial stress, it may lead to ill-will on the part of other farmers. They see financially troubled farmers gaining "unfair" advantages. Principal forgiveness represents a cost to the lender, and a principal buy-down is a cost to taxpayers. Both, however, do ease the debt burden of the financially stressed borrower.

3. Interest buy-down. This policy involves interest rate reductions

on an existing loan. The buy-down refers to the government paying a part of the cost of an interest rate reduction if the private lender will reduce the interest rate. On a 14 percent loan, for example, a 4 percent buy-down would lower the interest rate to 10 percent. Some part of the cost would be borne by the government and the remainder by the private lender. An interest buy-down speaks directly to the basic problem facing financially stressed farmers - too much debt service.

Interest rate buy-downs can be implemented in many ways, including a direct government payment, an increased tax write-off for farm interest payments, a public guarantee to reduce the risk faced by lenders (allowing lenders to charge a lower rate), and the use of tax-exempt revenue bonds to obtain lower cost funds for agriculture.

The effectiveness of an interest buy-down is directly related to the amount of the reduction. While it is relatively effective in reducing the debt service burden, it is also expensive. A 4 percentage point reduction in interest rates on all debt owed by farmers with debt-asset ratios over 40 percent would require about 4 billion dollars (Doye and Jolly).

The effect on lenders of an interest buy-down depends on the fraction of cost paid by the government and expected loss through default if the borrower is not given some relief. Probably lenders would utilize an interest buy-down for borrowers who could not make it otherwise, but they would resist for those who might survive by other means.

4. Foreclosure moratoria. Moratoria have received substantial

discussion. The purpose of a foreclosure moratorium is to stop proceedings to enable the financially stressed producer to gain temporary relief from excessive financial obligations. A key to the success of this approach is a relatively quick turnaround in the condition of the industry.

Moratoria as applied under the Frazier-Lemke Act in the 1930s affected only real estate loans (Munger and Feder). The farm was appraised, and the court granted a moratorium for three years. The farmer kept the property in his possession, continued to farm, and paid rent for its use. Within three years the farmer could pay the appraised value and redeem his property; if not redeemed, it was sold. The farmer was not liable for loan amounts greater than the lesser of the appraised value of the property or its sale price.

The moratorium approach limited farmer losses although it required some payment for use of the property. The main advantage, however, was that the courts could force creditors and borrowers to work out their differences. The experience of the 1930s was that relatively few farmers took advantage of this approach. Creditors quickly made adjustments in lending practices, reducing new loans in states which had moratoria. If applied today, one might expect that moratoria would raise interest rates to compensate for increased risk and costs in agricultural lending, decrease credit availability, but stabilize asset values since fewer assets would be forced onto the market.

More recently, attempts have been made to develop targeted or limited moratoria which limit the lender's right to foreclose. For example, a limited moratorium allows the lender to foreclose but only after he has made a "good faith" attempt to use all public sector credit assistance programs available. Or, the lender might be restricted from foreclosing for nonpayment of principal, i.e., the lender could foreclose only if the borrower falls behind on interest payments. In essence, conditional moratoria are a means to encourage the reluctant lender to cooperate with and assist those borrowers facing financial stress.

5. Inventorying or facilitating changes in ownership patterns of assets. A number of means could aid in this approach. For example, lending institutions might be encouraged to take title to propertly in lieu of debt obligations and lease the property back to the original debtor. Then other resources such as machinery and equipment would not require liquidation.

The lender would be converting a nonperforming asset into one generating at least some return. To avoid the problem of lender illiquidity from holding such assets, the government would likely need to provide funds (perhaps through the Federal Reserve discount window or sale of government-guaranteed bonds) in the amount of the transferred assets. Such government funds could be provided at lower cost than funds from the private sector, partly offsetting the lower return earned on rental. The lender might be required to remove the assets from its portfolio over a two- to four-year period. The original debtor would have first option to buy.

Government programs could also be initiated to hold repossessed land off the market. For example, FmHA is, in some places, already holding foreclosed land off the market for one to three years.

Private lenders could be assisted in other ways in holding land off the market. Bank regulations typically require that real estate assets taken over by the bank be valued at market first, and then be written down annually to discourage holding of such assets. The bank loses equity and is encouraged to dump assets. Some states even prohibit ownership of farm land by lenders or corporations, thus forcing repossessed farmland onto the market.

Methods should be considered to enable lenders to have more flexibility in recognizing the losses in their agricultural portfolio. A longer period over which assets are written down to market value (possibly 3-5 years) would allow the lender to offset the loss with future earnings rather than impair the capital base of the institution. Capital certificates provided by the U.S. government in the amount of losses on agricultural loans that must be amortized over time (5-10 years) may also be a useful mechanism for using time and future earnings to blunt the size of the losses on the financial viability of lending institutions. This procedure would involve government guarantees of the capital structure of the lender rather than part of the loan portfolio.

An alternative approach would be for a state or the federal government to charter an entity to acquire nonperforming real estate debt and the assets securing that debt from lenders (Harl). Acquisitions would be held off the market, perhaps leased back to the original farmer, or put into a conservation reserve program. Funding could come from sale of state or federally issued tax exempt bonds.

Programs to stabilize asset values have advantages and disadvantages. They are beneficial for farmers in financial trouble primarily by maintaining collateral values on their individual balance sheets. Such policies also permit lenders to exercise forbearance because of being in less severe financial circumstances themselves. There would be mixed benefits for farmers not in trouble. Asset values would remain at higher levels, so individual balance sheets would be less negatively affected. Untroubled farmers, or other investors wanting to expand their asset base, however, would have to pay more to acquire assets. Lenders, of course, would be most affected by such policies since the basic purpose of the policies would be to protect them. Consumers and taxpayers would benefit from the increased stability associated with meaningful programs to keep asset markets from overreacting downward.

6. Other. Three additional approaches deserve brief mention. Farm price and income policies have been a traditional approach to raise farm income and ease financial problems. Improved income from such policies would increase the debt service capacity of farmers and would stabilize asset values at higher levels. But, in the current situation, the traditional approach falls short because: (1) cash shortfalls for the bulk of distressed farmers are so great (Bullock, Economic Research Service), (2)

the policies are very expensive, and (3) needed adjustments of capital and resources out of the sector are restricted.

Monetary and fiscal policies clearly affect farmer well being given their direct impact on debt service costs, carrying charges, and dollar exchange rates. Lower real and nominal interest rates would be helpful to the entire agricultural sector.

Given market indications that resources, including human resources, need to exit agriculture, increased attention should be given to programs and policies to help people make the transition out of farming. For too long our efforts have worked to avoid exit rather than to assist in the adjustment out. Research studying displaced farmers gives disturbing results (Heffernan and Heffernan). Three quarters of displaced farmers stay in the community, but close to one half appear headed toward poverty. The personal trauma, social upheaval, and loss of productivity to the economy from ignoring this problem are a high price for society to pay.

CHANGING RURAL ATTITUDES

There is a fundamental concern that I would like to share concerning changing attitudes in rural communities that suggest increased polarization, divisiveness, and the potential for confrontation. I do not have numerical documentation for this changing attitude, but discussions with farmers and lenders suggest that it is real and increasingly pervasive. This changing attitude has at least three dimensions. First, business relationships in rural communities are deteriorating. Farmers who were willing to cooperate with their lender in making adjustments in prior years are taking a more protective-of-self stance. Merchants and dealers are less willing to operate without excessive legal documentation of transactions. Business people are becoming more suspicious and less trusting in their dealings. This "non-cooperative" attitude shows up clearly in the lending relationships where farmers use the threat of bankruptcy to gain accommodations from the lender. Some farmers are "building new houses," separating real estate and other assets from the farm business and their own personal ownership by transfers to children and other family members to protect property from creditors and have a base to restart if the "old house" - the current farm - is lost. Second, some farmers who have the financial ability to pay on their obligations are consciously debating whether they should do so. This is particularly the case with Farm Credit Systems borrowers where the discussions of financial assistance or a "bail out" are most frequent. The arguments for non-payment are threefold: first, the proceeds from those who do pay will be used to offset the losses of those who don't pay and, consequently, those farmers making their payments are subsidizing those who default; second, if there is some form of federal assistance, it will likely be targeted to those who are not making their payments, and so those who do pay will be penalized by not receiving direct benefits from any government assistance program; and third, massive defaults will put additional pressure on the public sector to provide assistance, and if such assistance is not forthcoming and the lender takes aggressive foreclosure action (which also would be unlikely if there are massive defaults on the part of borrowers), the payment could be made at the last minute during the redemption period without risk of losing control or ownership of the property.

These two behaviors noted earlier suggest a third concern about changing attitudes in rural communities. There appear to be changing standards of "honesty" or "commitment" in rural communities compared to earlier years. The "your word is your bond" attitude is no longer standard. Rural people are not necessarily becoming blatantly dishonest, but they are more willing to accept the grey area between "right" and "wrong" and accept less than "pure" business decisions. The reasons for this change in standards of honesty may be twofold: one, that peoples' standards sometimes are adjusted when financial survival is at stake, and two, farmers feel that their current financial problems are "not all their own fault" and that others - including lenders, business firms, and the government - are partly to blame, so it is justified to transfer part of the loss to others through defaulting on commitments. A fundamental question is whether these perceived changes in the "moral fiber" in rural communities are only transitory or permanent, and what they might imply concerning future business arrangements and even personal and social commitments of those who live in rural communities.

CONCLUSIONS

Data from many states along with that from the U.S. Department of

Agriculture indicate that a significant number of farmers are suffering financial stress. This stress is a result of the many changes in the financial environment for agriculture, and is not simply a result of lower incomes. Other factors that contribute to the financial stress problem of the U.S. agricultural sector are a higher debt load, shorter maturities on debt, reduced liquidity, higher and more volatile interest rates, increased income and collateral risk, limited availability of refinancing alternatives, and asset liquidations. Government policies of the past have contributed to today's financial stress by encouraging higher land values, more debt utilization, growth in farm size, and higher interest rates.

Given the complex nature of the financial stress problem, a public policy approach that focuses only on one characteristic of that problem will probably be ineffective. Specifically, price and income support programs which have been the major component of agricultural policy in the past may be quite ineffective in solving the current financial stress problem - such programs do not focus on some of the major dimensions of the stress problem (i.e., loan maturities, liquidity, collateral risk, etc.), and furthermore quite likely will not be targeted to those individuals who have financial stress. Such programs may in fact compound and contribute to the longer-run financial problems in agriculture.

Various policy options that are more targeted to the financial stress problem have been identified, including interest rate buy-downs, debt moratoriums, debt restructuring, asset restructuring, recapitalization, etc.

While spiraling farm debt suggests that debt restructuring is the answer to the current financial stress, a restructuring of agricultural assets remains the key to a long-term solution. The results of both firm level and the aggregate analyses indicate that asset restructuring through sale-leasebacks is a preferred option to interest rate buy-downs or liability restructuring in reducing financial stress for individual farm firms and the industry. The rearranging of liabilities is not a permanent solution to the current financial stress, because even with more time to repay, many farmers will not be able to service their debt with current or expected interest rates, productivity, and input and commodity prices. However, debt restructuring is an important mechanism for buying time to implement more permanent solutions. Asset restructuring including liquidation, debt reductions, and equity infusions will be required to improve the chances of long-term survivability of many farm businesses.

One of the key objectives of any public policy to alleviate financial stress should be to protect the resource markets from collapsing — stabilizing resources values is critical to maintaining the stability of the agricultural production sector and rural communities. If resource values decline precipitously because of excessive supplies being offered to a market that has no liquidity to absorb them, many farmers who were a "good credit risk" will no longer be so because of declining collateral values. But using government intervention to stabilize resource values at levels that are not supportable in the long run can result in very high government costs, inefficient resource allocation, and higher consumer prices for food products. Such a result is also clearly not desirable.

The agricultural sector has suffered significant wealth losses during recent years. An important public policy concern is how those losses will be shared among the various firms in the private sector (farmers, lenders, input supply firms, landlords, etc.) and between the public sector and the private sector. A related concern is how to keep the losses from becoming more severe than they need be. A strategy of doing nothing today could, if the financial condition of agriculture continues to deteriorate, very easily result in irresistable political and economic pressures to implement drastic options later such as a general and extended debt moratorium or significant increases in commodity support prices. But inappropriate action now may interfere with the longer-run adjustments in resource values and utilization that must occur to retain an efficient and financially sound agricultural sector.

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Table 1. U.S. Farm: Debts and Assets by Leverage

	Debt to Asset Ratio (percent)				
	0-10	11-40	41-70	71+	Total (%)
Operators (%)	58	24	11	8	100
Debt (%)	5	32	32	31	100
Assets (%)	47	32	14	8	100

Source: Melichar, January 1984 Federal Reserve Bulletin.

Table 2. Estimated Percentage Distributions of Sample Farm Operators, Their Assets and Liabilities by Relative Debt Levels*

	Debt to Asset Ratio (percent)			
	0-10	11-40	41-70	71+
Operators (%)	36	35	18	10
Assets (%)	30	40	21	9
Liabilities (%)	3	32	40	25

Source: *Farm Finance Survey*, March 1984, Iowa Department of Agriculture.

*Totals may not equal 100 due to rounding errors.

Table 3. Estimated Percentage Distributions of Iowa Farm Operators, Their Debt and Assets by Farm Size and Debt Level Categories*

		Debt-to-Asset Ratio (%)			
Farm Size**		0-10	11-40	41-70	71+
Very small	Number in Sample	13	7	7	5
	% Operators	41	22	22	16
	% Assets	39	25	25	11
	% Debt	0	25	41	34
Small	Number in Sample	61	45	25	17
	% Operators	41	30	17	11
	% Assets	41	31	18	11
	% Debt	3	25	33	38
Medium	Number in Sample	211	199	95	58
	% Operators	37	35	17	10
	% Assets	34	37	18	11
	% Debt	3	31	35	31
Large	Number in Sample	29	55	33	6
	% Operators	24	45	27	5
	% Assets	24	45	26	5
	% Debt	4	35	47	14
All	Number in Sample	314	306	160	86
	% Operators	36	35	18	10
	% Assets	30	40	21	9
	% Debt	3	32	40	25

Source: Farm Finance Survey, March 1984, Iowa Department of Agriculture.

*Totals may not equal 100 due to rounding errors.

**Size Category	Assets
Very small	Under $50,000
Small	$50,000-$199,999
Medium	$200,000-$999,999
Large	$1,000,000 and over

Table 4. Target Groups for Financial Policy

Group	Percent of U.S. Total Operators	Debt	Assets
Not restructurable[1]	15.1	27.6	8.8
Restructurable[2]	45.8	36.5	55.1
Profitable[3]	39.1	35.9	36.1

Source: 1984 Farm Costs and Returns Survey, USDA

[1] Insolvent or had a return to equity less than -20 percent.

[2] Return to equity from -20 to +5 percent.

[3] Return to equity greater than +5 percent.

Chairman LaFalce. Mr. Urbanchuk, please proceed.

STATEMENT OF JOHN M. URBANCHUK, DIRECTOR, INTERNATIONAL AGRICULTURE SERVICE, WHARTON ECONOMETRIC FORECASTING ASSOCIATES

Mr. Urbanchuk. Thank you, Mr. Chairman.

On behalf of Wharton Econometrics, I wish to express our appreciation for this opportunity to testify regarding our estimates of the potential impacts on the U.S. economy of the agricultural financial crisis and the potential for large-scale agricultural loan defaults.

Our analysis was performed using Wharton's long-term model of the U.S. economy and our agricultural market models. The Wharton analysis is the last in a sequence of four studies conducted jointly by Wharton and the Food and Agricultural Policy Research Institute at the University of Missouri-Columbia, and Iowa State University.

The analysis that was incorporated in our macro-simulations, draws heavily on financial stress surveys and other work that was done both at Missouri and Iowa State.

Before summarizing the results of our analysis, I would like to point out that Wharton Econometrics did not attempt to estimate the exact size of agricultural loan defaults, or their distribution throughout the full agricultural financial sector.

Instead, we outlined four potential default scenarios consistent with two separate farm policy environments and attempted to estimate the impacts on the U.S. economy if no action were taken to avert, or ameliorate, the financial crisis, as we have heard this morning, and it has been underlined several times.

Financial stress is widespread in U.S. agriculture. Recent financial surveys indicate that one-half to two-thirds of outstanding farm debt, $100 to $140 billion, cannot be fully serviced at existing rates of return and interest.

In other words, interest and principal cannot be paid in full and allow for capital replacement, consumption, and risk. This situation is clearly unstable.

In the long run, financial stabilization will be obtained through liquidation of assets or chargeoffs by lenders and contract sellers, or discharged through bankruptcy or foreclosure. Asset structure will change as farmers sell assets and lease them back from investors and through attraction of outside equity capital.

Changes in the financial structure of this sort take time. They don't happen overnight. Recent estimates indicate that 10 to 15 percent of U.S. agricultural assets may need to be liquidated to service the remaining debt.

It is unlikely that land, machinery, and livestock markets could rapidly absorb this volume of assets without significant further reductions in asset values and increased financial stress for farmers, lenders, and agricultural businesses.

To avoid severely depressing asset values, restructuring must take place over an extended period of time. Currently, it is unclear that either the farm sector or the agriculture credit industry has the financial reserves to support such an extensive adjustment.

Losses will be incurred by restructuring. These losses are borne in part by farmers through losses in equity as asset values decline or assets are liquidated below acquisition prices. Losses also will be incurred by lenders, individuals and agricultural businesses.

Their losses occur in the form of loan principal or interest charge-offs, discharged accounts payable, and losses from liquidation of acquired property at values below loan principal amounts.

Whereas losses in farmer's equity will influence future agricultural investment and consumption, losses to the financial and agribusiness sector will be passed more directly onto the rest of the economy.

Our analysis examined the impact on a baseline growth projection for the U.S. economy of four alternative farm sector loan losses. These range from a $50 billion default with no assistance under a complete "free market" type farm bill, very similar to the administration program that was released in the early part of 1985 to on the low end, a $10 billion default with special assistance to the financial sector and a more supportive farm bill.

However, we expect that the most likely scenario would involve a default of $20 billion spread over a period of time.

Again, I would like to state that these alternative analyses reflect the changes that are likely to occur in the economy as a result of an agricultural sector default of the stated magnitude when no special assistance is provided.

Econometric models permit economists to develop alternative future paths for the economy. Wharton used its econometric models to estimate the cost of the agriculture sector loan losses to output and employment levels that would have pertained without the loan losses.

While we still expect the economy to expand even with the large agricultural sector loan losses, the costs to the U.S. economy are substantial.

The primary impact of large-scale loan losses in agriculture will be felt in the private credit markets as general public confidence in the U.S. financial system waivers.

A large dollar volume of agricultural sector loan losses would produce large dollar losses to lenders, because of sharply lower agricultural land prices, which have fallen substantially over the last several years.

These land prices, along with the prices of the other assets used to secure the loans, would fall further as lenders attempted to liquidate assets. Under worst-case conditions, lenders might recover only 50 percent of loan values.

The large lender losses would cause a substantial number of commercial banks and farm credit institutions to fail. Most of the commercial banks that would fail are not going to be large financial center banks, but rather are smaller banks primarily in the rural areas.

Smaller banks, however, typically have correspondent relationships with large financial center banks, which participate in the loans made by the smaller banks. Also, larger money center bank holding companies own large blocks of stock in many smaller banks.

Therefore, a high loan loss rate among the smaller banks would also imply substantial losses and even potential failures for some of the large financial center banks.

As the public becomes aware of the extent of the losses within the financial sector as the failure rate rises, confidence in the banking sector would weaken. Large depositors will be among the first to withdraw funds because of the $100,000 limit on deposit insurance. This loss of deposits would put further pressure on weaker banks and could trigger bank failures.

Financial collapse is not a concern because of the presence of a safety net provided by the Federal Reserve Board and the U.S. Government. There are, however, serious adverse financial consequences from large-scale loan losses by the agricultural sector.

These are likely to occur as investors and depositors respond to the perception of increased risk in the public financial sector by shifting funds to government securities; thereby bidding up private sector rates relative to government rates.

We assume that the Federal Reserve will at some point intervene to prevent a widescale financial crisis. Intervention is likely to be a complicated process since agricultural sector debt is held by a wide range of institutions.

Some of these, such as most of the commercial banks which hold about 25 percent of outstanding farm debt, are insured by the FDIC. Others like the Federal Land Banks and Production Credit Association are not insured, but are federally chartered cooperative institutions. Congress would have to authorize a bailout if these institutions were to fail.

The major impact of large-scale loan losses on U.S. financial markets is expected to be an increase in private short-term interest rates. Our estimates of the short-term interest rate responses is based on earlier research that focused on the implications for the U.S. financial system of an international financial crisis and the specific effects of Latin American loan defaults.

Under the Latin American default analysis, a $20 billion default in 1985 was projected to produce a 225 basis point increase in short-term private interest rates, despite prompt Federal Reserve Board action. This result is consistent with the situation observed for the Continental Illinois National Bank case where, despite FDIC guarantees, outflows were large.

We estimate that a $20 billion agriculture sector loan loss would result in a maximum 75 basis point rise in short-term interest rates, considerably less than that estimated for the Latin American defaults scenario.

There are two primary reasons for this difference. First, in the agricultural sector case, major money market center banks are not directly involved. Most of the banks that are going to be involved are going to be smaller banks in rural areas.

Second, because of the restructuring that is involved, it is going to take place over a longer period of time, and we are assuming 3 years, not as quick an adjustment as we would have assumed under the Latin American case.

The potential amplitude and duration of the private sector interest rate increases would depend on the degree of erosion in public confidence in the financial system and the perceived risk associated with various debt instruments.

The specific timing and nature of the intervening actions taken by the Federal Reserve Board, the FDIC, the U.S. Treasury and the Congress will be key factors in determining the extent of the public's reaction to agricultural sector loan losses. As a result, the actual interest rate changes could be larger or smaller than we have estimated.

It is very difficult to try and perceive what the authorities are likely to do and when.

The important point that remains is that loan losses of the magnitude considered here would be sufficient to lead to a high failure rate among directly affected financial institutions, and to generate substantial concern among the general public regarding the viability of other financial institutions and instruments.

This public concern translates into demands for higher risk premiums on private-sector loan instruments and higher private short-term interest rates.

The macroeconomic impacts of a major agricultural sector financial failure stem directly from these higher interest rates. The loss in public confidence in the private financial markets that prompts the run up in rates is expected to occur despite strong intervention by the Federal Reserve and other Federal authorities.

This is because the intervention is assumed to be reactive rather than preemptive, in the sense that the intervention would occur after the loan losses occurred, in response to actual or imminent failure of financial institutions.

Agricultural sector borrowers will be faced with additional risk premiums on top of higher rates. We believe that Wharton's estimates of the interest rate impacts of the loan losses are conservative.

As shown by data presented in a recent USDA ERS study, previous shocks to the financial system have produced much sharper increases in interest rates.

The basic sequence of macroeconomic events resulting from large-scale agricultural sector loan losses is likely to follow this pattern:

Agricultural sector loan losses push up private interest rates. This increases capital costs for the entire economy and agriculture. We estimate that a $20 billion loan loss will push up private short-term interest rates by as much as 75 basis points. This results in a 1.7-percent increase in agricultural capital costs.

The second major impact, higher capital costs retard investment spending, which reduces productivity and output throughout the economy. Agricultural investment is reduced by $6 billion, in 1985 constant dollars, over the 1985–93 period, while total fixed business investment in the economy is reduced by $24.5 billion over the same period.

In more general terms, real GNP is lowered by $31 billion over the 1985–93 period.

The reduced output trims as many as 175,000 jobs from the economy and cuts real personal income by $12.2 billion. We are looking at the loss of as many as 59,000 jobs directly in agriculture.

The combination of lower employment and reduced personal income reduces Federal Government receipts, increases Federal transfer payments, and pushes up the Federal debt. By 1993, we estimate that the Federal debt would be $13.7 billion higher than if the agricultural sector loan losses were averted.

These significant negative macroeconomic impacts of agricultural sector loan losses are not preordained. They could be reduced substantially, if not eliminated entirely, if preemptive actions are taken to alleviate the existing farm credit crisis.

This preemptive action could take many forms, ranging from prompt and direct Fed intervention to a refinancing of the Farm Credit System with new debt issues that are guaranteed by an agency of the U.S. Government, or possibly tax exempt.

Unfortunately, the agricultural financial crisis is here. While intervention can treat the symptoms and reduce the impact, the only solution to the problem is a return to profitability in agriculture.

We are faced with a problem that we are going to have for some time, and the only way to solve it is to look for a combination of policies that return agriculture to a profitable footing.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Urbanchuk follows:]

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STATEMENT OF
JOHN M. URBANCHUK
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BEFORE THE SUBCOMMITTEE ON ECONOMIC STABILIZATION OF THE HOUSE BANKING, FINANCE, AND URBAN AFFAIRS COMMITTEE
OCTOBER 23, 1985

Good morning. My name is John M. Urbanchuk and I am the Director of International Agriculture Services at Wharton Econometrics in Philadelphia. On behalf of Wharton Econometrics, I wish to express our appreciation for this opportunity to testify regarding our estimates of the potential impacts to the U.S. economy of large scale agricultural loan defaults. Our analysis was performed using Wharton's Long-Term Model of the U.S. economy and our Agricultural Market Models. The Wharton analysis is the last in sequence of four studies conducted jointly by Wharton and the Food and Agricultural Policy Research Institute (FAPRI) at the University of Missouri-Columbia and Iowa State University.

Before summarizing the results of our analysis, I would like to point out that Wharton Econometrics did not attempt to estimate the exact size of agricultural loan defaults, or their distribution throughout the full agricultural financial sector. Instead, we outlined four potential default scenarios consistent with two separate farm policy environments and attempted to estimate the impacts on the U.S. economy if no action were taken to avert, or ameliorate, the financial crisis.

Financial stress is widespread in U.S. agriculture. Recent financial surveys indicate that one-half to two thirds of outstanding farm debt ($100 to $140 billion) cannot be fully serviced at existing rates of return and interest. In other words, interest and principal cannot be paid in full and allow for capital replacement, consumption, and risk. This situation is clearly unstable. In the long run, financial stabilization will be obtained through debt and asset restructuring. Debt levels will be reduced through liquidation of assets or charge-offs by lenders and contract sellers, or discharged through bankruptcy or foreclosure. Asset structure will change as farmers sell assets and lease them back from investors and through attraction of outside equity capital.

Changes in the financial structure of this sort take time. Recent estimates indicate that 10-15% of U.S. agricultural assets may need to be liquidated to service the remaining debt. It is unlikely that land, machinery, and livestock markets could rapidly absorb this volume of assets without significant further reductions in asset values and increased financial stress for farmers, lenders, and agricultural businesses. To avoid severely depressing asset values, restructuring must take place over an extended period of time. Currently, it is unclear that either the farm sector or the agriculture credit industry has the financial reserves to support such an extensive adjustment.

Losses will be incurred by restructuring. These losses are borne in part by farmers through losses in equity as asset values decline or assets are liquidated below acquisition prices. Losses also will be incurred by lenders, individuals, and agricultural businesses. Their losses occur in the form of loan principal or interest charge-offs, discharged accounts payable, and losses from liquidation of acquired property at values below loan principal amounts. Whereas losses in farmer's equity will influence future agricultural investment and consumption, losses to the financial and agri-business sector will be passed more directly onto the rest of the economy.

Our analysis examined the impact on a baseline growth projection for the U.S. economy of four alternative farm sector loan losses. These range from a $50 billion default with no assistance under a complete "free market" type farm bill to a $10 billion default with special assistance to the financial sector and a more supportive farm bill. However, we expect that the most likely scenario would involve a default of $20 billion spread over three years.

Again I would like to state that these alternative analyses reflect the changes that are likely to occur in the economy as a result of an agricultural sector default of the stated magnitude when no special assistance is provided.

Econometric models permit economists to develop alternative future paths for the economy. Wharton used its econometric models to estimate the cost of the agriculture sector loan losses by estimating the losses output and employment that would result relative to output and employment levels that would have pertained without the loan losses. While we still expect the economy to expand even with the large agricultural sector loan losses, the costs to the U.S. economy are substantial.

The primary impact of large scale loan losses in agriculture will be felt in the private credit markets as general public confidence in the U.S. financial system waivers. A large dollar volume of agricultural sector loan losses would produce large dollar losses to lenders, because agricultural land prices have fallen substantially over the last several years. These land prices, along with the prices of the other assets used to secure the loans, would fall further as lenders attempted to liquidate assets. Under worst case conditions, lenders might recover only 50% of loan values.

The large lender losses would cause a substantial number of commercial banks and farm credit institutions to fail. Most of the commercial banks that would fail are not large financial center banks, but rather are smaller banks primarily in the midwest. Smaller banks, however, typically have correspondent relationships with large financial center banks, which participate in the loans made by the smaller banks. Also, larger money center bank holding companies own large blocks of stock in many smaller banks. Therefore, a high loan loss rate among the smaller banks would also imply substantial losses and even potential failures for some of the larger financial center banks.

As the public becomes aware of the extent of the losses within the financial sector and as the failure rate rises, confidence in the banking sector would weaken. Large depositors will be among the first to withdraw funds because of the $100,000 limit on deposit insurance. This loss of deposits would put further pressure on weaker banks and could trigger additional bank failures.

Financial collapse is not a concern because of the presence of a safety net provided by the Federal Reserve Board and the U.S. Government. There could, however, be serious adverse financial consequences from large-scale loan losses by the agricultural sector. These are likely to occur as investors and depositors respond to the perception of increased risk in the public financial sector by shifting funds to government securities; thereby bidding up private sector rates relative to government rates.

We assume that the Federal Reserve will at some point intervene to prevent a wide scale financial crisis. This is likely to be a complicated process since agricultural sector debt is held by a wide range of institutions. Some of these, such as most of the commercial banks which hold about 25% of outstanding farm debt, are insured by the FDIC. Others like the Federal Land Banks and Production Credit Associations are not insured but are federally chartered cooperative institutions. Congress would have to authorize a bailout if these institutions were to fail.

The major impact of large scale loan losses on U.S. financial markets is expected to be an increase in private short-term interest rates. Our estimates of the short-term interest rate responses is based on earlier research that focused on the implications for the U.S. financial system of an international financial crisis and the specific effects of

Latin American loan defaults. Under the Latin American analysis, a $20 billion default in 1985 was projected to produce a 225 basis point increase in short-term private interest rates despite prompt Federal Reserve Board action. This result is consistent with he situation observed for the Continental Illinois national Bank case where despite FDIC guarantees, outflows were large.

We estimate that a $20 billion agriculture sector loan loss would result in a 75 basis point rise in short-term interest rates, considerably less than that estimated for the Latin American defaults scenario. There are two primary reasons for this difference. First in the agricultural sector case major money market center banks are not directly involved. The other reason is that the agricultural sector loan losses are expected to occur over a three-year period.

The potential amplitude and duration of the private sector interest rate increases would depend on the degree of erosion in public confidence in the financial system and the perceived risk associated with various debt instruments. The specific timing and nature of the intervening actions taken by the Federal reserve Board, the FDIC, the U.S. Treasury and the Congress will be key factors in determining the extent of the public's reaction to agricultural sector loan losses. As a result the actual interest rate changes could be larger or smaller than we have estimated.

The important point that remains is that loan losses of the magnitude considered here would be sufficient to lead to a high failure rate among directly affected financial institutions, and to generate substantial concern among the general public regarding the viability of other financial institutions and instruments. This public concern translates into demands for higher risk premiums on private sector loan instruments and higher private short-term interest rates.

The macroeconomic impacts of a major agricultural sector financial failure stem directly from these higher interest rates. The loss in public confidence in the private financial markets that prompts the run-up in rates is expected to occur despite strong intervention by the Federal reserve and other federal authorities. This is because the intervention is assumed to be reactive rather than preemptive, in the sense that the intervention would occur after the loan losses occurred, in response to actual or imminent failure of financial institutions. Agricultural sector borrowers will be faced with additional risk premiums on top of higher rates. We believe that Wharton's estimates of the interest rate impacts of the loan losses are conservative. As shown by data presented in a recent ERS study, previous shocks to the financial system have produced much sharper increases in interest rates.

The basic sequence of macroeconomic events resulting from large scale agricultural sector loan losses is likely to follow this pattern:

- Agricultural sector loan losses push up private interest rates, which increases capital costs for the entire economy and agriculture. We estimate that a $20 billion loan loss will push up private short-term interest rates by as much as 75 basis points. This results in a 1.7% increase in agricultural capital costs.

- Higher capital costs retard investment spending, which reduces productivity and output throughout the economy. Agricultural investment is reduced by $8 billion 1985 dollars over the 1985-93 period while total fixed business investment in the economy is reduced by $24.5 billion over the same period. In more general terms, real GNP is lowered by $31 billion over the 1985-93 period.

- o Reduced output trims as many as 175,000 jobs from the economy and cuts real personal income by $12.2 billion.

As many as 59,000 jobs would be directly lost in agriculture.

- o The combination of lower employment and reduced personal income reduces federal government receipts, increases federal transfer payments, and pushes up the federal debt. By 1993, we estimate that the federal debt would be $13.7 billion higher than if the agricultural sector loan losses were averted.

These significant negative macroeconomic impacts of agricultural sector loan losses are not preordained. They could be reduced substantially, if not eliminated entirely, if preemptive actions are taken to alleviate the existing farm credit crisis. This preemptive action could take many forms ranging from prompt and direct Fed intervention to a refinancing of the Farm Credit System with new debt issues that guaranteed by an agency of the U.S. Government, or possibly tax exempt.

Unfortunately, the agricultural financial crisis is here. While intervention can treat the symptoms and reduce the impact, the only solution to the problem is a return to profitability in agriculture.

Chairman **LaFalce**. Thank you very much.

I let each of you go on for as long as you desired, because I wanted every member of the subcommittee to have an opportunity to hear you in full.

Because of the hour, we will have to confine ourselves to the 5-minute rule.

Mr. Urbanchuk, you indicated in your last paragraph that the agricultural financial crisis is here. When preparing a statement, my staff came up with something similar, a crisis in farm financing, and I scratched the word "crisis."

I said sometimes you can create a self-fulfilling prophecy. I am not sure it has reached the crisis proportions. Perceptions are important.

Do we have a crisis on our hands right now, or is it a problem that, if dealt with, can perhaps prevent a crisis?

Mr. Melichar first.

Mr. **Melichar**. Certainly for the individual farmers who are in financial trouble, who are having difficulty servicing their debt, it is a personal financial crisis.

For the sector as a whole, the data indicates that there are far more farmers who are not in immediate financial difficulty. They are experiencing decreases in their wealth and are being affected, but I don't think you would characterize it as a crisis. The same thing at the agricultural banks, the majority are clearly not in a crisis.

We have this diversity in all facets of the sector.

Chairman **LaFalce**. The difficulty is so often public policy responses are fashioned on the basis of newspaper headlines that of necessity must use three or four words, and if the word is crisis, we might come forth with an immediate response or overresponse. Maybe it is a crisis, but I am thinking of it in terms of national perspective, as opposed to an individual, personal perspective.

Mr. **Irwin**. I would tend to agree. I would emphasize that probably 85 percent of the operating loans and well over 90 percent of the real estate loans are performing, they are on schedule on their payments.

It is the rest that create a major problem, and we have the carrying costs for those nonperforming. For the longer term, the problem for those good borrowers is that the problem accounts can drag down the financial institution, and then the farmers that survive don't have that institution to deal with.

Chairman **LaFalce**. As I heard Mr. Melichar, I thought he was saying that agricultural banks probably have a more serious problem with respect to nonperforming loans than does the Farm Credit System.

Mr. **Irwin**. Well——

Chairman **LaFalce**. Is that a fair characterization? Mr. Melichar?

Mr. **Melichar**. An appropriate characterization would be that there is not much difference between the two.

Chairman **LaFalce**. Should we be focusing on the problems of the Farm Credit System in isolation from the problems of agriculture banks, or should we view them hand in hand?

Mr. Irwin.

Mr. **Irwin**. Those data we are referring to are as of the beginning of this year. I think neither farmers nor mortgage lenders at the beginning of the year realized the extent to which there were potential losses in those loan portfolios.

There is now probably a little bit different perspective on the situation, but it is also a much different perspective for the real estate lender portion of the Farm Credit System than it is for the operating lending side of this system.

You can much more easily work out of a situation with an operating loan.

Chairman **LaFalce**. I see.

Let me ask this, Mr. Irwin. At the time that the Farm Credit System was created, it was difficult to access credit elsewhere. There are now many other lenders to farmers.

Is there still a need for the Farm Credit System, given the tremendous number of other agricultural lenders?

Mr. **Irwin**. I think, given the public philosophy toward the farming sector, which emphasizes something called a family farm size agriculture, you have to question that financial markets are perfect to agriculture at the current stage.

I think you would say that if you are talking about a major corporation, financial markets are very effective and very efficient. We are in an era right now where the agricultural sector is served by rural banks, who are under great stress by a number of other lenders who are marginally in and out of the sector, and by an increasing amount of activity from two agencies over in the Department of Agriculture, the Farmers Home and the Commodity Credit Corporation.

You can also speculate about what financial deregulation has done to the flow of savings versus the flow of loan funds. I think there would be a general conclusion that savings have been mobilized to money centers very effectively.

The creation of the money market account effectively liberated the farmers' savings and everyone else's savings to a market rate from that local bank account, and that facilitated assembling that money in large blocks in money centers and investing that money in large blocks.

I don't believe there is equivalent capacity to bring that money back out into a geographically diverse and complex lending environment that you have with an agricultural's seasonal nature, so I am not willing to buy that conclusion that perfection has been achieved in those markets.

Chairman **LaFalce**. No conclusion, it was just a question. My time has expired.

Mr. Shumway.

Mr. **Shumway**. Thank you, Mr. Chairman.

Just a few days ago, it was reported in the news that a report was issued by L.F. Rothschild, Underberg & Tobin, describing the Farm Credit System, and showing that its balance sheet as of June 30 reflected capital holdings of $9.2 million.

Risk capital for the system is measured more by retained earnings than loan loss reserves. The thought persists, at least it comes back in my mind as I review this problem, that this system, if indeed it is in trouble—and that is universally conceded—it should first be required to use up all its available resources to stabilize the situation, rather than running to Washington and have a hand-out for Government assistance.

Perhaps that may be needed, and I am not saying that isn't the case. Isn't there some way that we can require that it use up its own resources, to solve its own problems, before we get to this stage?

Mr. **Irwin**. I think you are right, and agrees with the position of the Farm Credit Board and the Farm Credit Administration. The Federal Board in its actions on September 5, took steps to establish a regulation which, as a last resort, would give the Governor of FCA the authority to mandate the movement of that capital around as needed, to deal with a situation.

I am less sure than you that it ought to use up all of those resources before looking for a Federal assistance. It seems to me that you always are dealing with a situation where, if the trend appears certain, then jumping in early with a little help may well stabilize more effectively than jumping in later as a last resort.

The other point I would suggest to you is that roughly half of that capital in the banks, and also in the PCA's which are measured separately, is in the form of borrower stock, because that is the nature of a cooperative system, you buy shares of stock.

It is an extremely important matter of concern to those farmer borrowers that that stock not be at the same level of jeopardy as their earned reserves, and it gets quite emotional.

Mr. **Shumway**. All right, that is something we are going to have to pursue obviously, because there are a number of questions I would ask on that subject.

Let me go on to Mr. Boehlje's statement.

You indicated that at the root of the problem here, we have the situation of too few farmers, and a concentration of debt. Now, I am not sure in what sense you meant that; that is, how it cuts across the agricultural community, whether you are talking about concentration in terms of commodities, lenders, geographics within the country, or how it might apply. However, I have some trouble digesting that thought, because it has been conceded—for example, taking one aspect of the agricultural community, such as the dairy industry, that we overproduce, and not a case of too few farmers, at least in that particular area.

How do you make that statement? Are you making it with reference to geography?

Mr. **Boehlje**. Your point is appropriate with respect to the issue of excess production. It is not clear we necessarily have too many dairy farmers.

Mr. **Shumway**. Isn't it the excess production that causes the problem, and drives the price down?

Mr. **Boehlje**. The excess production is part of the problem, excess production resulting in lower prices, but if you recall from the testimony, we indicated that this problem is not uniquely and exclusively a low price or even a low income problem.

There is excess production, and that results in one dimension of the problem. The point I made was that the distribution of debt is such that we have a small group of farmers with a very small land base trying to support a very large proportion of the total amount of debt in agriculture, a small group of farmers excessively leveraged, if you will.

Mr. **Shumway**. Would you recommend, then, that we have more people go into the dairy business?

Mr. **Boehlje**. No, I would not recommend that at all. We do need to differentiate between the number of dairy farmers, and the amount of milk being produced. I am not convinced we have too many dairy farmers, but I am convinced we have too many dairy cows, and too much milk production.

Mr. **Shumway**. You would rather see the herd divided up among more farmers?

Mr. **Boehlje**. That might be a possibility. These are different types of problems. The income problem is a problem of excess. Too much farm production nationwide, but the problem of debt, it seems to me, has an additional dimension.

There is too much debt, but if the debt was evenly distributed across the entire farm population, if every farmer would take their fair share, it would all be serviceable.

Chairman **LaFalce**. If Chrysler's debt were shared by GM and Ford, Chrysler wouldn't have a problem, right?

Mr. **Boehlje**. There is going to have to be a reduction of that debt, or, giving that property back to the lending community, a transfer of the debt obligation to other people.

Chairman **LaFalce**. Mr. Vento.

Mr. **Vento**. Mr. Boehlje, I understand you are still traveling back and forth down to Iowa. It is good to see you here. All of the statements are very good, Mr. Melichar's statement and all the others, and they deserve our close attention.

I think the area of innovative ideas, the very point that Mr. Shumway is making in terms of banks, financial institutions, farm credit or whoever is holding that land for a period of time, not so that the market does not deteriorate further, is a very, very important point.

That is one of the policies that we deal with, and one that the Farm Credit Administration is going to have to deal with so they don't aggravate or compound the situation on the basis of disposal of that land.

Do you care to comment on that?

Mr. **Boehlje**. I am not sure I should say much more, except that I think that is a very critical concern. Land values are declining for a number of reasons in the Midwest, and other parts of the country, but one is excessive supplies being offered to the market, and limited liquidity, and limited funding to purchase.

We just have too much land that wants to move given the number of potential buyers out there, and that is going to result in continued declines in prices. That has to be stabilized.

Mr. **Vento**. The Government can deal with it on a regulatory basis.

The other concern I have, I wish to briefly comment about this, should any of these program initiatives, the Farm Credit System or others, with regard to banks, focus at all in terms of trying to reach down and keep the people on the land; that is, to permit farmers to continue doing some of the activities that they are doing as opposed to just rescuing the credit system, whether it is the bank or the Farm Credit System?

Mr. **Boehlje.** I don't think we do, in the long run, solve the financial institutions' problem unless we improve the creditworthiness of its loan portfolio, and its customer base.

We have got to help the farm sector, or the financial institutions with bad paper are going to continue to have problems.

We can't just continue to bail out lenders without solving the fundamental root problem of the agricultural sector.

The second dimension is, we need to recognize that some farmers may have to change their relationship to their asset base, and they may not have to exit farming, but they may have to give up some ownership rights and be recycled as operators of that land, not owners.

Mr. **Vento.** Someone else sharing the risk, in terms of ownership of the land.

Mr. **Boehlje.** Exactly.

Mr. **Vento.** The comparison, the financial institution credit versus the financial credit system, I happen to think you need to be there by virtue of having a third of the debt today or more, based on whatever the audit is from Price Waterhouse that is coming out, some of the bonds you are selling are also held by banks, and furthermore, that—well, I mean, that is a point right there.

If they are holding 50 percent of the land, and in addition, holding some of the bonds, that is a big problem.

Please address, if you draw down on your assets, what does that do to the interest rates on your bonds?

Mr. **Irwin.** Well, it is true that commercial banks are involved both directly by lending to farmers, and indirectly by making investments in farm credit securities, which are based on loans to farmers.

Mr. **Vento.** Do you have any figures for us?

Mr. **Irwin.** There are no accurate data. The best judgments are in the 40-percent range. The fact is, though, that a security holder is in a much more secure position than the maker of a loan, and as long as those financial institutions in between have any equity in them, you are not jeopardizing security holders at this stage, I don't think.

Mr. **Vento.** The interest rates on your bonds, if you draw down your assets?

Mr. **Irwin.** Well, the—it is obviously a potential problem, and in the case of the Farm Credit System, there is the important dimension of what is agency status, because those securities do sell in the agency market.

It is clearly the case that rates have gone up in the short term in response to whatever risks have been perceived there. It is clearly the case that at some point of drawing down capital, you wouldn't be able to sell securities.

I guess our viewpoint is, one wants to admit that kind of a problem early and head it off and prevent that from becoming a possibility.

Mr. **Vento.** The concern is that the selling of bonds would further up the interest rate that is going to be paid by the farm sector, if it is drawn down very far.

Thank you, Mr. Chairman. My time has expired.

Chairman LAFALCE. Mr. Bereuter.

Mr. BEREUTER. I have so many questions to ask that it is hard to know how to start.

Mr. Irwin, you say on page 5, you refer to the three major dimensions, but I think if you were not trying to be kind, you would say the three major contributing factors to our problems today, and one you mentioned, is the anti-inflation strategy of the early eighties.

That needs to be emphasized as a very basic cause of our problem today. Unless this message gets across loud and clear, that the no-growth for 6 months, and the rapid decline in M-1 instead of the projected reduction in half, in 6 years, three-quarters of it came the first year, unless we have a clear understanding of this monetary policy basis, we are not going to get the political consensus necessary to take action.

Mr. IRWIN. I think that you have to say that there is a fundamental misjudgment on the first factor; that is, the demand growth factor, and the only thing the anti-inflation policy did was speed up the rate at which the export markets were cut back.

You would have to say regardless of the inflation policy, the adjustment to that first force was going to take place sometime in the eighties.

Mr. BEREUTER. We won the war against inflation, but the primary casualties were the people that had agricultural real estate and debt on that. Those casualties are continuing to be agriculture credit facilities.

Mr. Melichar, you say things are not as bad as they look, but I have a hard time finding that in the statistics behind that statement, because each of those statistics reflects real people and farms. Also, I think that Dr. Boehlje makes many good points, but one that needs to be reemphasized is what he refers to on page 5, the impact upon the ag input supply firms, Main Street America in small communities, because they are all in that category.

You may have many troubled agricultural banks, those with 25 percentage or more of their portfolio in agricultural loans, but all of the rest as well are agriculture-dependent, and if you bring down those farmers, you are also bringing down the whole community. That is why people failures are also bringing down the whole community. That is why people are not paying taxes, and whole institutions are being devastated.

I would say to Governor Wilkinson through you, Mr. Irwin, he is at least 8 months too late realizing we have a problem. When Congress was ready to take up this concern last February, before we got involved in the farm bill, we could have taken action and averted some of these problems. But now we are well along in the process.

I have been trying to convince the administration that what we are talking about is the end of the economic recovery, as well as a severe blow to the deficit reduction plan.

Now, let me come back to a question for Mr. Urbanchuk. You spell out an additional $20 billion in national debt, averaging $5 billion per year over 1989, in a Wharton study of last July. You also mention a potential $13.7 billion higher deficit in your prepared remarks.

Why are you now not as discouraged as during the July one?

Mr. **Urbanchuk**. I am having a hard time tracking down that number.

Mr. **Bereuter**. I refer to the Wharton study done for the corn growers. Congress has decided what the emphasis of the farm bill is going to be, income maintenance heavy the first few years, then we move toward a more market-oriented situation.

Given that scenario, what do you project?

Mr. **Urbanchuk**. Given that scenario, and that would come under the $20 billion default, that is a much more accomodative bill. By 1993, a Federal debt would be $13.7 billion higher.

Mr. **Bereuter**. My time is up. But let me just send a message to the Farm Credit System. We have a major revenue gap in the Omaha District at a time when the credit system executives are proposing salary increases of 5 percent. Also Federal employees' salaries are not going to go up.

It is very unpopular with the farm borrower, and it makes it much more difficult for us to have any kind of assistance program out of the Congress.

Thank you, Mr. Chairman.

Chairman **LaFalce**. Mr. Carper.

Mr. **Carper**. Welcome to our witnesses, and thank you for your testimony.

I wish to follow up on Mr. Bereuter's last question here. My question has been partly answered, what is the impact of the House-passed farm bill likely to be on the farm credit situation?

Mr. Urbanchuk, you had a chance to address that.

Mr. **Urbanchuk**. We have partially. We have not finished our analysis of the full version of the House bill. That analysis is not quite complete.

The bill, as I understand it, does not vary tremendously from the farm program option that we have built into the $20 billion default scenario that I have outlined for you, so I would not, on the surface, again without going through the detailed analysis of this, expect that we would see a major difference in impacts.

I would say on an order of magnitude, we are looking for the same kind of a basic scenario. Clearly, it is not as severe as had we had a very, very free market, very short-term adjustment forced on agriculture, but I think a key point is that the only way that this problem is going to be solved in the long run is by adopting a series of policies that permit a transition to take place in agriculture, and the House bills goes a long way along those lines, so I would suggest that the impacts that I have outlined are in the order of magnitudes.

Mr. **Carper**. I would be interested in what the other panel members might have to say.

Mr. Irwin.

Mr. **Irwin**. As I indicated in my comment on the economic outlook, it seems to me that given the size of this crop, we are virtually certain to be in a surplus situation for the next 2 to 3 years, and that means whatever level is established in that farm bill is the level upon which one can forecast farm net income, debt repayment ability of individual payment, so I agree that it is much more favorable for people being able to service debt, assuming they comply with those programs. In fact, what we will have this fall is a great deal of difference among individual farmers, depending upon whether or not they have taken advantage of the 1985 farm program, and therefore, are dealing off support levels rather than the current market price levels.

Mr. **Melichar**. I have not done that sort of analysis.

Mr. **Boehlje**. Even with financial assistance as indicated in the House version of the bill, there still will be a financial stress problem in agriculture.

That will not completely alleviate the problem, and we still have a significant amount of costs in addition that have to be paid by someone.

Mr. **Carper**. Mr. Urbanchuk, you mentioned on page 6, if we assume $20 billion loss, that might push up short-term interest rates by as much as 75 basis points.

What period of time might those rates stay at that level?

Mr. **Urbanchuk**. The problem is protracted in the sense that it takes place over a 3-year period of time, so rates go up and they stay at higher levels for a longer period of time than we have seen in other kinds of problems in the past.

The analysis ranged from 1985 through 1993, with the problem spread out over the 1986 through 1988 period of time, and we have that 75 basis point ranging in 1987 is when we hit it. We are dealing with an annual as opposed to a quarterly model. It is difficult to say it will occur over a 60-month period of time. We do for the year 1987, get a 75 basis point increase in the short term rates.

Mr. **Carper**. In 1987 or 1988 that point spread would disappear?

Mr. **Urbanchuk**. By 1988, that will go back down and by the time we get through that 3-year period of time, interest rates will converge back to where they would have been otherwise. You get a bulge peaking in 1987.

Mr. **Carper**. Page 7 of your testimony you mentioned that by 1993 you estimate the Federal debt would be $13.7 billion higher than if the agricultural sector loan losses were averted, and I would presume that that is a net figure.

What if no Federal intervention were undertaken, no appropriations were made, would we be $13.7 billion better off in terms of less Federal appropriations in another area?

Mr. **Urbanchuk**. Not necessarily. Generally we are looking at costs as a factor through the entire economy. That is one element of the issue; but keep in mind that we have outlined several economic impacts.

The increase in transfer payments, for example, that results from lower levels of unemployment, reduced receipts because of lower levels of activity, they enter into that as well. If you reduce that amount in some other area, you will come out a little bit further ahead, the increase in the debt may not be that large, but you will still get an increase in Federal debt, I believe.

Mr. **Carper**. Thank you.

Chairman **LaFalce**. I will now call upon the remaining members in the order in which minority counsel advised me they came into the hearing.

Mr. Wortley.

Mr. **Wortley**. I certainly want to commend you for starting the ball rolling in recognition of the agricultural credit problem. I hope by focusing some attention on it, we can come up with some reasonable solutions.

As far as I am concerned, much of the problem of agricultural credit is the responsibility of those in the farm credit service whose management leaves something to be desired, or maybe it is the lack of regulations. I don't believe the FDIC or the FSLIC has anything to do with regulating your industry, because you have no deposits. I don't think the Federal Reserve is involved in any regulations.

Am I correct on that?

Mr. **Irwin**. Note that the agency I work for is the one responsible for regulating the Farm Credit System.

Mr. **Wortley**. The Federal Reserve has nothing to do with it. You regulate yourself.

I don't think you do a very good job of regulating yourself. If you were doing a better job, you would have known what was coming.

Do you actually go in and conduct audits of the various——

Mr. **Irwin**. Yes, sir, that is one of the primary responsibilities of the agency.

Mr. **Wortley**. Who trains the personnel to do this?

Mr. **Irwin**. I can answer that generally—and if you want to go into detail?

Mr. **Wortley**. Just in general terms.

You are training your own policemen, is that right?

Mr. **Irwin**. The Farm Credit Administration is chartered as a Federal agency in reporting to a Presidential appointee board.

The farm credit banks are a private set of institutions and the perception seems to exist that it is all one and self-regulating, but on closer examination, you will see that there is an aura of distance.

The board has recommended as of September that the Farm Credit Administraton needs additional enforcement powers in dealing with the farm credit banks.

Mr. **Wortley**. Aren't your 12 banks all rather autonomous?

Mr. **Irwin**. There are 37 banks that are more or less autonomous.

Mr. **Wortley**. Is there any uniform accounting system that is used throughout this entire system, or does everybody have their own system?

Mr. **Irwin**. We have reporting standards in FCA on the material the banks are required to file with us now on a quarterly basis, and one of the situations you find yourself in is that we are now putting numbers in cells that used to be empty, like nonperforming loans. There were not any in the agricultural sector for a long period of time. But the standards we apply, with the exception of a couple, are generally accepted accounting principals.

Mr. **Wortley**. Do you think you have been doing a good job?

Mr. **Irwin**. Generally.

Mr. **Wortley**. Why didn't you see the crisis, foresee it?

Mr. Bereuter said many months ago, he directed it to the attentin of the administration.

Mr. **Irwin**. The only thing that has changed in our perception has been to say that we now believe the trends are such that the System does not have the internal resources to handle it.

We will not disagree that there was a problem a year ago, or even more than that. We were simply saying, we believe internally the farm credit banks can and should use their own resources to deal with it. The change, as of September 4, was to say it now appears that crop conditions and other developments make that unlikely, and therefore——

Mr. **Wortley**. Well, Mr. Melichar is an economist, and didn't he foresee some of the problems that were going to develop?

Don't you folks talk back and forth?

Mr. Melichar.

Mr. **Melichar**. Some of the problems could be seen developing in the 1970's. There were early warnings. The tractorcades of 1976–77, were early warnings that if farm income were to decline, there would be a set of farmers in financial difficulty. Back then it was a relatively small group that was in immediate financial difficulty when income did decline, but income recovered nicely in 1978–79 and gave new life to the boom and to expectations that, in fact, the world food supply would have trouble keeping up with world food demand. And it was not until in the 1980's that you got a 180° change not only in income expectations, but in the interest rates as well, and the people that had incurred a lot of debt were really stuck. That became evident, early in the 1980's—1981 and 1982—and the Farm Credit System was fully aware of it at that time.

Mr. **Wortley**. Did you start making any recommendations?

Chairman **LaFalce**. I am afraid, Mr. Wortley, that your time has expired.

Mr. **Wortley**. Thank you, Mr. Chairman.

Chairman **LaFalce**. I am going to call upon Mr. Grotberg, for his 5 minutes of questioning. At this time we will take a recess for approximately 10 minutes, and we will reconvene so that Mr. Leach, and Mr. McCandless can ask questions, and Mr. Bereuter, myself and others can have a second round.

Mr. **Grotberg**. Thank you, Mr. Chairman.

Mr. Irwin, how many of your agencies are in the public bond market, just your own agency or others, or divisions of the Farm Credit System?

Mr. **Irwin**. The Farm Credit System's 37 banks issue a consolidated bond which is the obligation of all of them.

Mr. **Grotberg**. Thank you, sir.

Revenue expenditures are not popular this year, but Mr. Urbanchuk, somewhere in your shop is a bill I introduced by request that would make all agribonds tax exempt, which presently are not. I wonder Mr. Urbanchuk, whether or not you have had a look at the cost effectiveness of that bill. A handful of farmers from Illinois thought this might be a route to go.

Mr. **Urbanchuk**. Yes, we have. We have conducted, or I should say we are in the midsts of conducting, the study is not completed. We identified a volume of lending to be covered by tax-exempt issues, somewhere in the area of $60 billion, and that is what we feel would be required in order to provide a sufficient capital base.

Mr. **Grotberg**. Revenue impact on $60 billion annually?

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Mr. **Urbanchuk**. The revenue impact, the revenue cost to the Treasury is $2.5 billion a year.

Mr. **Grotberg**. That is not a huge number?

Mr. **Urbanchuk**. Not a very large number in the aggregate sense.

The point we show looking at the macro-analysis, the benefits that are achieved through, again, the output against, or, I was going to say, the lower losses with output in employment, I don't believe it is a wash, and turns out to be beneficial on the agricultural side.

What we find is the use of the tax-exempt bonding issue actually tends to subsidize interest rates to agriculture and brings those rates down by about 300 base points.

Mr. **Grotberg**. Three hundred?

That covers less developed countries as well?

Mr. **Urbanchuk**. That is correct.

Not only were the issues that we looked at tax exempt, but they were also guaranteed as well, so the interest rate benefits are derived from both of those factors, the guarantees as well.

Mr. **Grotberg**. Mr. Chairman, I don't know if anybody knows that this bill was ever filed, except Mr. Urbanchuk and me, and Ed Madigan; and it might be something we might want to look at.

Thank you very much.

Chairman **LaFalce**. Thank you very much.

The subcommittee will recess until approximately 12:30 p.m.

[Brief recess.]

Chairman **LaFalce**. The subcommittee will reconvene.

The chair recognizes the gentleman from Iowa, Mr. Leach.

Mr. **Leach**. Thank you, Mr. Chairman.

I appreciate these very timely hearings that you have held.

Mr. Irwin, in your statement you have listed three of the major causes of the problems, and I agree with all three. I think they are very profound, very thoughtful.

To pursue Mr. Wortley's comments, left out is any analysis of self-responsibility. These are all abstract factors you listed outside your control.

There have been some aspects of the Farm Credit System that many have observed over time that they are not new this month, 8 or 9 months ago, and they have been present for a long time, and one has been lack of regulatory vigor. Did lending institutions give bonuses for making loans that occurred within your system? In probably as profound a legal case relating to agriculture as I know in this century, 2 weeks ago in Washington, Iowa, a jury reheld that the Farm Credit System had a fidiciary obligation to a farmer, a farmer family, and that in a unanimous decision, the Farm Credit System has a judgment of $1.5 million against it for a farm family that had been foreclosed on.

I am not sure that judgment wouldn't be reversed in appeal, both in size and in fact. It is not my business as a legal provision, but the whole case really symbolizes in the marshalling of evidence the lack of rigor and accountability within the System, and the inducement of the System to make loans, or at least the bias of the System to make loans, that makes it partly responsible for the inflationary impulses that occurred in agriculture, and that leaves us with, where do we go from here?

One aspect of that is that it strikes me that all aspects of the System are not the System itself but the people that make investment decisions in the System on a bond holder basis.

It is my understanding the Farm Credit System has gone to the executive and suggested an approach that might be somewhat expensive. It is my understanding that perhaps the executives had some concern about the size of the approach and, therefore, we are all back to square one, where we are.

It has been my feeling from the beginning, if we had a small problem, the Congress would certainly bail it out but if the problem were of more than modest size, we are going to have real problems figuring out where resources are coming from. It is your bad luck that you have a problem coming before the Congress at a time of great budgetary restraint.

If one can not look to the infusion of resources, you have to look to the reduction of liabilities and that means some sort of bond holder accountability.

That is why I have introduced an approach that stipulates, based upon a good solid assessment of how much liabilities exceed assets in the System, that perhaps the bond holder ought to be accountable for that margin of difference and then loans be guaranteed to the bond holder on a percentage of par basis with, in effect, the bond holder taking somewhat of a hit.

May I ask you two questions?

One, do you think you can present this committee a time period in which the System with the support of the administration is likely to present any approach; and second, this particular approach, will that be one that will be seriously considered by yourselves as you deal with the System, with the Government?

Mr. **Irwin**. You are referring to what, the bond holder?

Mr. **Leach**. Yes.

Mr. **Irwin**. It is always very tricky to try to speculate on when something may happen on a problem this big.

About all I can be sure of is, we have stated what we believe is a problem. There have been some internal approaches to, within FCA, to look at some options that might work. I think the understanding of everyone, though, is that it is a very broad problem.

It affects congressional concerns. It affects other lenders. It affects financial markets.

It certainly affects both the administration and the Congress in a number of areas in which they may operate, so our approach has been a very flexible one.

Here is something to bring to the table but let's talk about what might work. And so far as I know, there is not any attempt to prerule out any kind of a possibility that would seem to make sense. I can't deal with specifics because I am not directly involved in any of those negotiations.

Mr. **Leach**. I appreciate that.

Let me then ask Mr. Melichar, and I realize you are an economist and not representative of a seat on the Federal Reserve Board, but the Fed is as knowledgeable of this issue as any institution within the Federal structure, and if there is a time period between some difficulties in the System, and potential congressional or executive action, the Fed obviously has two options.

One, to purchase bonds, and the second is to open the discount window.

The bond option might be difficult because the System has indicated it needs a Federal bailout and you have only the authority to buy bonds for liquidity but not solvency purposes.

A, is that correct?

B, are you prepared to open your discount window to take care of short term problems within the System?

Mr. **Melichar**. I think we would be concerned only with the liquidity aspects of the problem, and would have no role to play with the solvency aspects; that is, with the bad loans.

A liquidity problem would be when the Farm Credit System needs to rollover an issue of maturing securities or perhaps to raise new funds—although that has not been necessary lately—and finds that investors do not want to purchase all of the new issue, or of the issue that is being rolled over.

If that happened, it does seem likely that the Federal Reserve would consider using the discount window. The Federal Reserve Act does contain a provision stating that the Federal Intermediate Credit Banks have access to the discount window.

It is certainly something that would come into play.

Chairman **LaFalce**. I am going to ask two quick questions and then go to Mr. Bereuter, and then we are going to adjourn the hearing.

First comment is that if there is to be any type of Federal assistance, it would seem to me that it is going to be imperative that those being assisted somehow share the burden that the taxpayer is going to be asked to carry directly or indirectly through the form of Federal assistance. So in your thinking, are you trying to devise of ways where all would have to share the sacrifice that would be necessary to help alleviate the problems that are being experienced?

Mr. **Irwin**. That is taken as a give in in anything we are doing.

You do not have a borrower coming to you until he is already in the situation that he has taken substantial losses, and is virtually at the point of zero; so he has taken about as much sacrifice as there is.

The lending organizations then have been taking loss at the second level, and I would point out that, I believe commercial banks wrote off about $900 million last year and the Farm Credit System, $428 million, and both will have substantial additional amounts this year.

As you recognize in the financial numbers I gave you, there is substantial solvency yet in the Farm Credit System. The approach that our Board has taken is that if the banks do not voluntarily put their resources to work first, then we shall have the authority to require them to do it. That is a precondition going into any kind of discussions, and the question is, is that enough or does there have to be something else beyond that?

Mr. **Boehlje**. Some of the proposals for interest rate buydowns recognize this by asking the local lender to take part in that interest rate buydown, and other proposals share the cost between Federal, State, and local lender, so there is a very wide perception that we have to share the burden.

Chairman **LaFalce**. My last question, and I wanted to give you both additional opportunity, out of deference to the fact they come from Nebraska and Iowa, and they are sharing a large portion of this burden.

Maybe we should be coming forth in the future in response to administration requests with some in the Federal assistance for the Farm Credit System, but I have difficulty, conceptually at least, seeing why we should help the Farm Credit System if we are not going to help agriculural banks; but then I have difficulty, if we are going to help agricultural banks, in trying to figure out why we shouldn't also be of assistance to S&L's, to those banks having difficulties because of energy loans, difficulties because of Third World debt loans and perhaps a great many other entities too, other than banks or financial institutions. Can you help me wrestle with my difficulty?

Mr. **Urbanchuk**. You raise a very good point. The use of tax exempt funding, one of the issues that comes up——

Chairman **LaFalce**. You can use tax-exempt funding for Third World.

Mr. **Urbanchuk**. That is exactly right. Why should one sector be given a benefit others don't get. One has to look at the total agricultural sector right now and the strategic importance, and as you indicate in your opening remarks, and some of the other members have also indicated, we are at a watershed right now as what happens with regard to the next several years in terms of restructuring, that agriculture will undergo is really going to do an awful lot to shape the size and composition of the agricultural sector, and our ability not to so much feed ourselves as a nation 5 years from now, but clearly our ability to compete in world markets.

So we are looking at a considerable sector of the economy that is undergoing substantial structural change. Any time you go through that kind of change, a lot of things can go wrong, you don't know what is going to come out the other end, so we are looking at a sector that deserves some consideration.

Chairman **LaFalce**. I think I agree with you regarding the fundamental structural change, but I also understand your background is agricultural economics, as is the background of every member at the witness table, but if we looked at the other structural changes taking place in our society, we could say we are going from a transformation in an industrial economy to a postindustrial economy; and, therefore, what assistance should we give to the manufacturing sector, the industrial sector which probably has experienced a crisis parallel to the crisis of the farming sector?

I don't know.

We could do this throughout society, though, and that is a real problem that we have to wrestle with as we try to fashion the correct approach to this problem. We have to see the whole.

I am sympathetic, but my sympathy is larger than just for this area.

Mr. **Irwin**. I am sure you would get two different kinds of requests from sectors so affected. One is a kind of request that assumes you are going to try to head off the adjustment from taking place, the other is that you are trying to stabilize against social impacts that are otherwise going to occur.

We are talking about the latter kind of thing in the agricultural sector, and those who look in the first direction are not being realistic.

Chairman **LaFalce**. Individuals could debate your analysis, Mr. Irwin.

Mr. **Irwin**. I can too, I guess. It seems to me that what you are dealing with is, will there or will there not be some smoothing out of this rate of change?

The fundamental argument you can make for the Farm Credit System is that first the agriculture sector continues to need a viable system, it is a public interest to provide it, and the other forces that I alluded to earlier, that inflation control was largely on the backs of the agricultural sector, and, therefore, there are some bases for public sharing.

Chairman **LaFalce**. Thank you very much, Mr. Irwin.

And thank you all, gentlemen, for a very educational and informational hearing.

We will be having additional hearings in the very, very near future, before any decisions are made as to what type of policy response should be formulated.

Thank you.

The subcommittee is adjourned.

[Whereupon, at 12:55 p.m., the hearing adjourned.]

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THE PROBLEMS OF FARM CREDIT

WEDNESDAY, NOVEMBER 13, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 2:20 p.m., in room 2167, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce, Representatives Torres, Carper, Shumway, Wortley, Bereuter, McCandless, Grotberg, and McMillan.

Also present: Representative Leach.

Chairman **LaFalce**. The subcommittee will come to order.

This marks the second in a series of hearings our subcommittee has scheduled on this issue. At our first hearing last month, a group of economists presented a general economic overview of the problem.

At today's hearing, we will consider whether the Government should have a role in the economic stabilization of the Farm Credit System. In hearings tomorrow and next week, we will explore the farm credit problem from the perspective of the Farm Credit Administration, commercial banks lending to farmers, farmer organizations, agencies supervising farm lenders, and Members of Congress. Our press release announcing these hearings included a rather extensive list of questions that should be resolved before Congress completes action.

Our subject today, the Farm Credit System, is a major economic institution that is not well known outside of the farm community. It is a farmer-owned cooperative system that includes land banks, production credit associations, and banks for cooperatives. With almost $70 billion in loans, the Farm Credit System is one of the largest banks in the country. Unlike commercial banks, it obtains its funds from the sale of bonds in the national money markets. It has traditionally been able to borrow almost as cheaply as the Federal Government.

The Farm Credit System prospered along with the farm economy during the 1970's. In fact, its mortgage loans have increased sevenfold since 1970. Some farmers, particularly younger farmers, took on substantial debt in the boom years of the 1970's. The Farm Credit System was able to build up a healthy cushion of earned surplus. That earned surplus still exceeds $5 billion.

In the 1980's, farm prices and incomes have fallen sharply. As a result, the bottom has fallen out of the demand for farm land.

Land values have been cut in half in some grain-belt States. Many of the more highly leveraged farmers are not making operating profits to cover their loan payments. Farm lenders, including the Farm Credit System, have been finding that their delinquent payments are escalating.

The Farm Credit System expects losses of almost $3 billion this year. Farmers are consequently having to pay more for the typical variable interest rate loan from the Farm Credit System. The Farm Credit System has been keeping interest rates up to put aside reserves as a provision for future loan losses. In addition, as its financial difficulties have received more attention, it has been forced to pay almost a percentage point more to borrow money. These two pressures may increase interest rates to farmers further as Farm Credit System losses mount and it must roll over its bonds.

The Farm Credit Council, the trade group representing the Farm Credit System, fears that the Farm Credit System will deplete most of its $7 billion in earned surplus and loan loss reserves over the next couple of years. It contends that the Federal Government must provide substantial financial backing to assure a market for new Farm Credit System bonds at competitive rates. It has proposed legislation to provide the Farm Credit System with a $6 billion line of credit from the Treasury to be exercised over the next 3 fiscal years.

For its part, the Reagan administration has questioned the need for such financial backing and agreed thus far only to study the need for financial assistance. To give assurance to the bond market, it has urged that the Congress promptly enact legislation to reform the Farm Credit Administration and to permit more stressed regions to draw more readily on the funds of healthier regions.

We are very fortunate to have with us today three witnesses who are very knowledgeable about the financial problems facing the Farm Credit System and their implications for the wider economy. Frank Naylor, Under Secretary of Agriculture, has himself worked in the Farm Credit System in the past, and now oversees the credit issue at the USDA. Assistant Secretary of the Treasury Charles Sethness handles this issue for that department. Douglas Sims is president of the Bank for Cooperatives in St. Louis and a member of the legislative committee of the Farm Credit Council.

Before we call upon the witnesses, I would call upon our ranking minority Member, Mr. Shumway, for any statement he might have.

Mr. SHUMWAY. Thank you, Mr. Chairman. Like you, I look forward to hearing from our distinguished panel of witnesses today, as we explore in greater detail the problems confronting both the borrowers and the lenders in America's agricultural sector.

This is not an easy topic to address. Nor is it an easy one to find solutions to. The issues and equities are blurred due to the emotional clouds that hang over us. The American farmer and his ways of life are major touchstones of our Jeffersonian heritage.

Hence we feel their pain as television, magazines and newspapers report increased foreclosures, shattered lives, and lost lands, as their economy and way of life deteriorates at a precipitious rate. The lenders to this sector, the agricultural banks and the Farm

Credit System, have also taken their toll as the negative impact begins to ripple outward.

The Farm Credit System, holding approximately one-third of total farm debt, is at a critical juncture today. According to its calculations, it faces depletion of its earnings and loan loss reserves if Federal financial assistance is not forthcoming. Its bond market is under great stress, because confidence in farm credit bonds has been undermined by the current state of affairs.

The commercial agriculture banks which hold approximately one-fourth of the total farm debt are also in jeopardy. More importantly, they are also the largest purchasers of farm credit bonds. As the number of failures within their ranks increase, pressure is placed on the Federal deposit insurance funds and ultimately the entire financial system.

This scenario would make even the most hard-hearted individual recoil. Indeed, it makes us shudder to ask the hard questions, but ask we must, and not let emotions interfere with real life solutions. For example, I believe we must ask a most basic question, and that is, does the present system serve and enhance the public interest or only the interests of a particular sector of our economy. What policies must be changed that will foster rehabilitative relief without providing windfalls, not to mention imposing an inordinate burden on the American taxpayer.

These are difficult questions. The answers will not be easy. However, we are privileged to have witnesses today that are in the best position to discuss the hard questions and provide us with their valuable insight. It will definitely help this subcommittee to peruse through the scrambled data and move in a positive direction.

Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you, Mr. Shumway.

Our first witness will be Mr. Frank Naylor of the Agriculture Department.

STATEMENT OF FRANK W. NAYLOR, JR., UNDER SECRETARY FOR THE SMALL COMMUNITY AND RURAL DEVELOPMENT, DEPARTMENT OF AGRICULTURE

Mr. NAYLOR. Thank you, Mr. Chairman. We appreciate this opportunity to appear before your committee. We appreciate the opportunity to share with you our assessment of the current status of the Farm Credit System.

I have a prepared statement which I ask to be submitted for the record, if that is acceptable to the chairman.

Chairman LAFALCE. Without objection, so ordered.

Mr. NAYLOR. Mr. Chairman, the cooperative Farm Credit System serves as one of three key links of credit supply to the agricultural community in this country. Currently, there is about $125 billion of agricultural debt outstanding, of which the principal sources are the commercial banks, the Farmers Home Administration, a government agency, and the cooperative Farm Credit System, which holds approximately a third of the total outstanding agricultural debt.

More significantly, within that debt, they hold approximately half of the total real estate debt for agriculture in the United States.

The administration has been in the process of an intensive administration wide review of the operating conditions, strengths and weaknesses of the operating Farm Credit System. As part of that review, we have carried on extensive discussions and reviews with representatives of the operating system, their independent accountants, Price Waterhouse, and the Governor and senior staff of the Farm Credit Administration.

There are issues and problems being faced by the System, which are unusually complex and varied. But it is the administration's view that despite the System's probable need to reserve upward of $6 billion for losses over the next 3 years, their very substantial resources in the form of earned surplus, capital and loan loss reserves, provide significant strength which will let them work their way through this very difficult period before returning to a positive position in their operations, based on their projections in 1988.

The Department of Treasury has carried on a very intense review of the assessment of the System's current conditions, Mr. Chairman. My colleague, Mr. Sethness, the Assistant Secretary for Domestic Finance, is prepared to share with this committee an extensive and detailed review of the assessment of the Department of Treasury, which also accurately reflects the view of the Department of Agriculture. With your permission I ask that he present that statement to you.

[The prepared statement of Mr. Naylor follows:]

Frank W. Naylor, Jr., Under Secretary for the
Small Community and Rural Development
Department of Agriculture, Nov. 13, 1985

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Summary of the Administration's Position on the Farm Credit System

The Administration is in the process of an intensive Administration-wide review of the operating conditions, strengths and weaknesses of the operating Farm Credit System. As part of this review, extensive discussions have been conducted with representatives of the operating system, their independent accountants Price Waterhouse, and the Governor and the senior staff of the Farm Credit Administration.

While the issues and problems faced by the Farm Credit System are unusually complex and varied, it is the Administration's view that the system's projections of the necessity of reporting substantial losses during the next two years in the magnitude of $2.5 billion from the fourth quarter of the current year and $1-1/2 billion for each of the next two years is based on reasonably prudent economic assumptions. Based on the assumption made by the operating system and its accountants, the system, after taking the appropriate steps to reserve and manage its problem loans, should return to a positive operating position in 1988.

The operating system, including its associations, continues to have a very strong financial balance sheet. As of September 30, it has loan loss reserves totaling some $1.6 billion, earned net worth of $5.5 billion and member stock totaling $5.3 billion. This $12.4 billion in funds, coupled with a high percentage of loans which continue to perform adequately, provides the capacity and the potential in our view for the system to be able to effectively work in its own behalf to remain an effective and viable lender if provided with the necessary tools to do so.

Therefore, the Administration proposes:

First, creating authority for an internal Farm Credit System entity that would mobilize the system's earned surplus in order to absorb operating losses and manage troubled loan assets.

Second, restructuring the Farm Credit Administration into a true arm's length financial regulator whose authorities would include matters of entry and exit, capital, safety and soundness, and enforcement of supervisory directives.

If Congress is willing to legislate both (1) the self-help changes that will enable FCS to tap its own considerable resources, and (2) the reform of FCA into an independent supervisor, the Administration will assess the need for Federal financial assistance.

We believe the best mechanism for handling the System's bad asset problem is to permit the Farm Credit System's Capital Corporation (FCSCC), established under the FCS, to:

a) acquire from financially troubled System institutions loans and property at no greater than market value;

b) assume or issue obligations, that would be jointly and severally guaranteed by the FCS, so as to carry the assets while they are being held, leased, or restructured in an orderly fashion;

c) obtain earned surplus from those operating units which have it and transfer it to those which are in deficit; and

d) assess the operating units to capture sufficient future earnings as support for FCSCC's debt service obligations and operating losses, subject to existing FCA regulations to transfer capital.

We believe the best mechanism for ensuring a permanent solution to the System's operating problem is to provide a strong and effective financial regulatory agency with authority broadly similar to that regulating nonfarm financial institutions.

The reformed regulatory authority should be provided with general powers that include:

a) restructuring of present management board with a single Chairman appointed by the President and confirmed by the Senate;

b) general rulemaking authority and examination and enforcement powers;

c) power over exit and entry to the system, including approval and/or requiring mergers; and

d) authority to establish capital requirements and safety and soundness provisions.

The Administration is convinced that the actions I have just outlined will assure a steady supply of available credit for farmers and ranchers at reasonable rates. Further, these actions will help stabilize declining land values by assuring that precipitous liquidation of land loans can be avoided. This stability in rural credit markets will assist all farm borrowers, even those who are not participants in the Farm Credit System.

In addition, it should be remembered that FmHA loan guarantees are available to qualified farm credit borrowers and that most farm credit associations are FmHA approved lenders.

Chairman LaFalce. Mr. Sethness, please proceed.

STATEMENT OF CHARLES O. SETHNESS, ASSISTANT SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. Sethness. It is a pleasure to be here today to discuss the administration's proposals with regard to the Farm Credit System. As you know, over the last several months the administration has been reviewing the structure of the Farm Credit System and the System's financial condition.

It has become apparent that basic structural reforms are necessary to permit the Farm Credit System to utilize its own substantial resources effectively to solve the System's financial problems and to assure the viability of the System in the future.

A few background comments on the size of the Farm Credit System problem.

The Farm Credit System, a privately owned cooperative chartered by the Congress, will incur very large loan losses between now and the end of 1987. Systemwide losses are expected to amount to up to $2.5 billion in the rest of 1985 and $1½ billion in each of 1986 and 1987 before the System will achieve a marginal profit in 1988. Interest income will offset only a small portion of these losses.

These expected losses should be assessed within the context of the Farm Credit System's capacity to absorb them. At the end of September, Farm Credit System capital totaled $10.8 billion including $5.5 billion of earned surplus and $5.3 billion of borrower-owned stock. The System also had loss reserves totaling $1.6 billion. Under the current statutory structure, the System has had difficulty mobilizing these resources to deal with loan loss problems.

Moreover, there has been considerable uncertainty in the financial community regarding the extent of system loan losses and the System's ability to deploy its own considerable resources to cope with these losses. As a result, securities market investors have insisted on larger risk premiums—of as much as 1 percentage point—on farm credit securities, so that the Farm Credit System has had to pay relatively more to roll over its maturing debt. It is worth noting that the System's borrowing cost spread over Treasury securities has improved somewhat over the past week, and is currently only 30 to 50 basis points worse than other "agency" borrowers for longer maturity paper.

The Farm Credit System must be able to refinance its debt to remain a key source of credit for farmers. Since all of the institutions in the System draw on systemwide securities issuance to fund their lending activities, they are all dependent upon its financial health. There were $68.3 billion of Farm Credit System notes and bonds outstanding on September 30.

The System problem has developed in part because the System's regulator, the Farm Credit Administration, has had neither the tools to intervene properly nor the distance from the System to develop and enforce an independent supervisory judgment.

The unfortunate result of these interrelated problems has been increased pressure on farm borrower stockholders in the System.

Because the System has had difficulty mobilizing its resources, farmers in particularly distressed areas have had to pay higher interest rates, worry about their stock investments in the System and undergo loan restructurings without access to the cushion of all of the cooperative system's collective surplus.

The administration recognizes the vital role that the System plays for the Nation's farmers and is alert to the need to maintain the System as a privately owned organization that is sensitive to market forces rather than to Government dictates. The administration agrees with the desire of the System's borrowers to retain the cooperative nature of the System, including local management of the lending institutions.

We believe the congressional preference for helping ailing financial institutions to help themselves is the appropriate approach to the problem. In this connection, direct Government support would increase the deficit and spur demands of others seeking "equal treatment."

So long as it can borrow at reasonable interest rates, the System's large earned surplus and loss reserves will assure that it can remain a viable lender—even with estimated losses of $5.5 billion for the rest of 1985 through 1987. Not only must the System have the will, it also must have the capability to tap its own considerable resources for the benefit of the whole System. That is what a cooperative is all about: All stand together.

The System needs two basic changes. First, it must have the capability to mobilize its earned surplus, under appropriate supervision, so as to deal effectively with bad loans and to provide assurance that borrower-owned stock is cushioned by systemwide resources. More orderly restructuring of loans, where prudent, would be possible and would alleviate pressure to liquidate associations. Second, the Farm Credit Administration must be reorganized and reformed so that it will operate as an independent regulator of the System.

The reform that the administration is proposing will deal effectively with the System's problems over the longer term. They are No. 1, self-help changes that will enable the System to tap its own considerable resources, and No. 2, reform of the Farm Credit Administration into an independent supervisor. If Congress is willing to legislate both of these reforms, the administration will further assess the need for Federal financial assistance. There is definitely no need for financial assistance now—and it would be a mistake to grant it, given the need for prompt legislative action.

With regard to self-help, the administration recommends establishing an entity that could mobilize all system units' earned surplus, purchase bad system loans at market value, restructure such loans and assess system institutions to cover the entity's debt service costs and any losses. The Farm Credit Administration, which would be reformed into a financial institution regulator, would charter and supervise a Farm Credit Capital Corporation. The Chairman of the Farm Credit Administration would establish the initial capitalization from the system banks' and associations' earned surplus. The Capital Corporation would have the authority, subject to Farm Credit Administration supervision, to:

Purchase assets at market value from troubled Farm Credit System institutions;

Assume or issue Farm Credit System obligations, in accord with its joint and several liability with other Farm Credit System institutions, to finance asserts being leased or restructured in an orderly fashion;

Assess Farm Credit System banks and associations to cover its expenses; and administer capital assistance among Farm Credit System institutions.

The Farm Credit System Capital Corporation's authority would be limited to that of other Farm Credit System institutions, except as stated specifically to enable systemwide self-help.

Second, the administration proposes substantial reform of the Farm Credit Administration and its regulatory authorities to make it broadly similar to Federal supervisors of depository institutions. Under this approach, the new Chairman of the Farm Credit Administration would be appointed by the President, subject to Senate confirmation, and the current Federal Farm Credit Board would serve as an advisory committee. The Farm Credit Administration would have the power to establish capital requirements and safety and soundness regulations and to enforce supervisory directives. Annual, independent, outside audits in accordance with generally accepted accounting principles would be required.

Moreover, legislation should provide for Farm Credit Administration authority over entry and exit of institutions in the System, including power over mergers, and should delete delegations of authority to the System and various powers that are inconsistent with the role of an effective supervisory agency.

Finally, the reform legislation should specify borrowers' rights pertaining to disclosure, access to documents, prompt review of credit decisions, and shareholders' actions against Farm Credit System officer-directors in accord with corporate law.

I would like to spend a few minutes on Farm Credit System capacity to handle financial problems.

The System appears to have sufficient earned surplus and current earnings to enable it to absorb its projected losses without jeopardizing stock held by borrowers, despite a large volume of nonperforming loans held by system institutions. Despite this, the System has asked for very large cash infusions of taxpayers' funds, although the amount of their request seems to keep falling as scrutiny of their projections proceeds.

The System's assessment of its ability to absorb losses is too conservative in several ways. First, the system's debt-to-capital ratio of approximately 8:1 compares favorably with other sponsored agencies; FNMA's leverage ratio, for example, is 70:1. Second, the System has been reluctant to tap the earned surplus of system banks totaling $3.6 billion and system associations totaling $1.9 billion as of September 30, 1985. Third, system institutions, which fear the flight of good borrowers who can obtain credit elsewhere, believe competition will force them to compress the net interest margin on good loans—but these spreads are already considerably below historical levels.

While the System's concerns regarding competition and borrower flight have some validity, such concerns are clearly not sufficient to warrant considering Federal assistance at this time. Many system competitors also face financial difficulties, and it is questionable whether a large number of system borrowers could repay their land loans—currently about $48 billion of the System's portfolio—with credit from alternative sources in today's market environment.

Some system bankers have expressed a concern over having to increase their interest rates to farmers sharply if their earned surplus is shared with other units. We believe that this is not necessary as long as the system comes to understand that many units will have to show losses—and should, given their asset quality problems—and that they have full systemwide earned surplus available to absorb those losses. All they have to do for continuing good borrowers is maintain historical spread levels over borrowing costs that are still lower than for many private corporations.

Retained earned surplus and loss reserves should enable the system to continue to operate as a viable lender, with the possibility of returning to breakeven or minimal profitability in 1988. The data in the table below combine estimates for the System banks and associations and is based on Farm Credit Administration and system estimates for the 1985–87 period. These estimates include further land value declines of 20 percent nationwide and up to 35 percent on the hardest hit areas. The data simply extrapolates 1987 to 1988. It indicates that there would be $5.0 billion of capital in the System at the end of 1988, $0.7 billion of which would represent earned surplus, even after absorbing all of the losses on the nonaccrual loans currently in the portfolio.

Implicit in these estimates is that the value of farmer-borrower stock in System institutions would be preserved, except for those borrowers who cannot keep their loans up. Also, Farm Credit System assumptions about holding nonearning assets do not appear to envision a very aggressive foreclosure and disposal process.

[The chart referred to follows:]

Farm Credit System Financial Condition
($ Millions)

	1984a	1985e	1986e	1987e	1988e
Net income	373	(2,800)	(1,340)	(1,412)	small but positive
Surplus	6,200	3,400	2,100	700	700+
Total Capital	11,800	8,700	7,000	5,000	5,000+
Loan Loss Reserves	1,300	3,300	3,000*	2,300*	*
Capital as a % of Assets	13.5%	10.6%	9.2%	7.8%	7.8%+

* These estimates depend on the rate at which charge-offs are incurred to reflect foreclosures and restructurings. We used FCS's assumptions about holding non-earning assets, which do not envision an aggressive disposal process.

Mr. SETHNESS. In summary, while the Farm Credit System is burdened by the weight of a heavy volume of nonperforming loans in institution portfolios, it has substantial financial resources to deal with the problems. The administration is recommending legislative reforms that will facilitate the distribution of system resources to institutions that are most in need. We are also proposing a major restructuring of the regulation of the Farm Credit System to prevent problems from occurring in the future, so that the financial viability of the Farm Credit System will be assured.

We believe that the debt markets will remain open to FCS at reasonable cost as long as the restructuring and reform legislation allowing them to help themselves moves promptly. Trying to devise Federal financial assistance approaches at a time when they are not needed would undermine the effort to get FCS to pay its own bills and complicate the process of getting them what they really need.

Mr. Chairman, that completes my statement. I will be glad to answer any questions that you have.

Thank you.

[The prepared statement of Mr. Sethness follows:]

FOR RELEASE ON DELIVERY
EXPECTED AT 2:00 PM
November 13, 1985

STATEMENT OF CHARLES O. SETHNESS ASSISTANT SECRETARY OF THE TREASURY (DOMESTIC FINANCE) BEFORE THE SUBCOMMITTEE ON ECONOMIC STABILIZATION OF THE HOUSE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here to discuss the Administration's proposals with regard to the Farm Credit System. As you know, over the last several months, the Administration has been reviewing the structure of the Farm Credit System and the System's financial condition. It has become apparent that basic structural reforms are necessary to permit the Farm Credit System to utilize its own substantial resources effectively to solve the System's financial problems and to assure the viability of the System in the future.

The Farm Credit System Problem

The Farm Credit System, a privately-owned cooperative chartered by the Congress, will incur very large loan losses between now and the end of 1987. Systemwide losses are expected to amount to up to $2.5 billion in the rest of 1985 and $1-1/2 billion in each of 1986 and 1987 before the System will achieve a marginal profit in 1988. Interest income will offset only a small portion of these losses.

These expected losses should be assessed within the context of the Farm Credit System's capacity to absorb them. At the end of September, FCS capital totaled $10.8 billion including $5.5 billion of earned surplus and $5.3 billion of borrower-owned stock. The System also had loss reserves totaling $1.6 billion. Under the current statutory structure, the System has had difficulty mobilizing these resources to deal with loan loss problems.

Moreover, there has been considerable uncertainty in the financial community regarding the extent of System loan losses and the System's ability to deploy its own considerable resources to cope with these losses. As a result, securities market investors have insisted on larger risk premiums (of as much as one percentage point) on Farm Credit securities, so that the Farm Credit System has had to pay relatively more to roll over its maturing debt. It is worth noting that the System's borrowing cost spread over Treasury securities has improved somewhat over the past week, and is currently only 30-to-50 basis points worse than other "agency" borrowers for longer maturity paper.

The Farm Credit System must be able to refinance its debt to remain a key source of credit for farmers. Since all of the institutions in the System draw on systemwide securities issuance to fund their lending activities, they are all dependent upon its financial health. There were $68.3 billion of Farm Credit System notes and bonds outstanding on September 30.

The System problem has developed in part because the System's regulator, the Farm Credit Administration, has had neither the tools to intervene properly nor the distance from the System to develop and enforce an independent supervisory judgment.

The unfortunate result of these inter-related problems has been increased pressure on farm borrower stockholders in the System.

Because the System has had difficulty mobilizing its resources, farmers in particularly distressed areas have had to pay higher interest rates, worry about their stock investments in the System and undergo loan restructurings without access to the cushion of all of the cooperative System's collective surplus.

The Need for Reform

The Administration recognizes the vital role that the System plays for the Nation's farmers and is alert to the need to maintain the System as a privately-owned organization that is sensitive to market forces rather than to Government dictates. The Administration agrees with the desire of the System's borrowers to retain the cooperative nature of the System, including local management of the lending institutions.

We believe the Congressional preference for helping ailing financial institutions to help themselves is the appropriate approach to the problem. In this connection, direct Government support would increase the deficit and spur demands of others seeking "equal treatment."

So long as it can borrow at reasonable interest rates, the System's large earned surplus and loss reserves will assure that it can remain a viable lender -- even with estimated losses of $5.5 billion for the rest of 1985 through 1987. Not only must the System have the will, it also must have the capability to tap its own considerable resources for the benefit of the whole System. That is what a cooperative is all about: All stand together.

The System needs two basic changes. First, it must have the capability to mobilize its earned surplus, under appropriate supervision, so as to deal effectively with bad loans and to provide assurance that borrower-owned stock is cushioned by System-wide resources. More orderly restructuring of loans, where prudent, would be possible and would alleviate pressure to liquidate associations. Second, the Farm Credit Administration must be reorganized and reformed so that it will operate as an independent regulator of the System.

The Administration's Proposal

The reform that the Administration is proposing will deal effectively with the System's problems over the longer term. They are (1) self-help changes that will enable the System to tap its own considerable resources, and (2) reform of the Farm Credit Administration into an independent supervisor. If Congress is willing to legislate both of these reforms, the Administration will further assess the need for Federal financial assistance. There is definitely no need for financial assistance now -- and it would be a mistake to grant it, given the need for prompt legislative action.

With regard to self-help, the Administration recommends establishing an entity that could mobilize all System units' earned surplus, purchase bad System loans at market value, restructure such loans and assess System institutions to cover the entity's debt service costs and any losses. The Farm Credit Administration, which would be reformed into a financial institution regulator, would charter and supervise a Farm Credit Capital Corporation. The Chairman of the Farm Credit Administration would establish the initial capitalization from the System banks' and associations' earned surplus. The Capital Corporation would have the authority, subject to Farm Credit Administration supervision, to:

- ° Purchase assets at market value from troubled FCS institutions;
- ° Assume or issue FCS obligations, in accord with its joint and several liability with other FCS institutions, to finance assets being leased or restructured in an orderly fashion;
- ° Assess FCS banks and associations to cover its expenses;
- ° Administer capital assistance among FCS institutions.

The FCS Capital Corporation's authority would be limited to that of other FCS institutions, except as stated specifically to enable systemwide self-help.

Secondly, the Administration proposes substantial reform of the Farm Credit Administration and its regulatory authorities to make it broadly similar to Federal supervisors of depository institutions.

Under this approach the new Chairman of the Farm Credit Administration would be appointed by the President, subject to Senate confirmation, and the current Federal Farm Credit Board would serve as an advisory committee. The Farm Credit

Administration would have the power to establish capital requirements and safety and soundness regulations and to enforce supervisory directives. Annual, independent, outside audits in accordance with generally accepted accounting principles would be required. Moreover, legislation should provide for Farm Credit Administration authority over entry and exit of institutions in the System, including power over mergers, and should delete delegations of authority to the System and various powers that are inconsistent with the role of an effective supervisory agency.

Finally, the reform legislation should specify borrowers' rights pertaining to disclosure, access to documents, prompt review of credit decisions, and shareholders' actions against FCS officer-directors in accord with corporate law.

Farm Credit System Capacity to Handle Financial Problems

The System appears to have sufficient earned surplus and current earnings to enable it to absorb its projected losses without jeopardizing stock held by borrowers, despite a large volume of nonperforming loans held by System institutions. Despite this, the System has asked for very large cash infusions of taxpayers' funds (although the amount of their request seems to keep falling as scrutiny of their projections proceeds.)

The System's assessment of its ability to absorb losses is too conservative in several ways. First, the System's debt to capital ratio of approximately 8:1 compares favorably with other sponsored agencies; FNMA's leverage ratio, for example is 70:1. Second, the System has been reluctant to tap the earned surplus of System banks totaling $3.6 billion and System associations totaling $1.9 billion. (There are also systemwide loss reserves of $1.6 billion.) Third, System institutions, which fear the flight of good borrowers who can obtain credit elsewhere, believe competition will force them to compress the net interest margin on good loans -- but these spreads are already considerably below historical levels.

While the System's concerns regarding competition and borrower flight have some validity, such concerns are clearly not sufficient to warrant considering Federal assistance at this time. Many System competitors also face financial difficulties, and it is questionable whether a large number of System borrowers could repay their land loans (currently about $48 billion of the System's portfolio) with credit from alternative sources in today's market environment.

Some system bankers have expressed a concern over having to increase their interest rates to farmers sharply if their earned surplus is shared with other units. We believe that this is not necessary as long as the System comes to understand that many units will have to show losses -- and should, given their asset quality problems -- and that they have full systemwide earned surplus available to absorb those losses. All they have to do for continuing good borrowers is maintain historical spread levels over borrowing costs that are still lower than many private corporations.

Retained earned surplus and loss reserves should enable the System to continue to operate as a viable lender, with the possibility of returning to breakeven or minimal profitability in 1988. The data in the table below combine estimates for the System banks and associations and is based on Farm Credit Administration and System estimates for the 1985-87 period. (These estimates include further land value declines of 20% nationwide and up to 35% on the hardest hit areas.) It simply extrapolates to 1988. It indicates that there would be $5.0 billion of capital in the System at the end of 1988, $.7 billion of which would represent earned surplus. Implicit in these estimates is that the value of farmer-borrower stock in System institutions would be preserved, except for those borrowers who cannot keep their loans up. Also, FCS' assumptions about holding non-earning assets do not appear to envision a very aggressive foreclosure and disposal process.

Farm Credit System Financial Condition
($ Millions)

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Loan Loss Reserves	1,300	3,300	3,000*	2,300*	*
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* These estimates depend on the rate at which charge-offs are incurred to reflect foreclosures and restructurings. We used FCS's assumptions about holding non-earning assets, which do not envision an aggressive disposal process.

Summary

While the Farm Credit System is burdened by the weight of a heavy volume of nonperforming loans in institution portfolios, it has substantial financial resources to deal with the problems. The Administration is recommending legislative reforms that will facilitate the distribution of System resources to institutions that are most in need. We are also proposing a major restructuring of the regulation of the Farm Credit System to prevent problems from occurring in the future, so that the financial viability of the Farm Credit System will be assured.

We believe that the debt markets will remain open to FCS at reasonable cost as long as the restructuring and reform legislation allowing them to help themselves moves promptly. Trying to devise Federal financial assistance approaches at a time when they are not needed would undermine the effort to get FCS to pay its own bills and complicate the process of getting them what they really need.

Mr. Chairman, that completes my statement. I will be glad to answer any questions that you have.

Chairman **LaFalce**. Thank you very much, Mr. Sethness, for an excellent presentation.

I should note that it is the first presentation Mr. Sethness has made before a congressional committee in his capacity as Assistant Secretary of the Treasury for Domestic Finance.

And it is all downhill after that, Mr. Sethness.

Mr. **Sethness**. That is not dramatically encouraging, Mr. Chairman.

Chairman **LaFalce**. Before we go to the fun part, Mr. Sethness, and ask you questions—and that will be a lot more fun than just reading the statement—we will hear perhaps a slightly different perspective regarding the farm credit problem and proposed solutions to that problem, from Mr. Douglas Sims, president of the St. Louis Bank for Cooperatives.

Mr. Sims.

STATEMENT OF DOUGLAS D. SIMS, MEMBER, FARM CREDIT COUNCIL LEGISLATIVE COMMITTEE, AND PRESIDENT, ST. LOUIS BANK FOR COOPERATIVES, EXECUTIVE VICE PRESIDENT, FARM CREDIT BANKS OF ST. LOUIS

Mr. **Sims**. Thank you, Mr. Chairman. It is a pleasure for me to be here today to represent the Farm Credit Council at this hearing. I have a prepared statement which I would submit to the committee for the record and cover the highlights of that, with your blessing.

Chairman **LaFalce**. Without objection, so ordered.

Mr. **Sims**. The banks and associations of the Farm Credit System are directed by law to serve the credit and financial service needs of U.S. agriculture. As was stated earlier, it is farmer owned and farmer directed, and we view it as the agency's pipeline from Wall Street to rural America. It is dedicated to obtaining those funds from the money markets, and then lending those funds on a reasonable and dependable basis to U.S. farmers, ranchers, and their cooperatives.

The Farm Credit System provides nearly one-third of the total agricultural credit, and approximately half of the long-term real estate loans. In size, it is nearly equal to the third largest bank in the United States. Two weeks ago, we appeared before the House Agriculture Committee's Subcommittee on Conservation, Credit and Rural Development, and we requested a $6 billion line of credit from the Treasury to help the Farm Credit System and its 1 million farmer borrower-owners deal with the problems we are facing.

We were proposing a warehouse for our bad loans with the funding assistance of the Government. I would like to review just a few of the key questions that are most frequently asked about that. First, we are not asking for a grant but for a loan to be repaid, as has been done in the past by the Farm Credit System.

Second, we are seeking assistance only for the Farm Credit System, but that does not mean that other lenders to the industry are not experiencing the same difficulty as the Farm Credit System, nor does it mean they should be excluded from some type of assistance program.

The vehicle we propose is designed to be a financial warehouse which could be modeled or adapted for other institutions.

Third, the system has taken upon itself, to help itself, including writing off nearly $4 billion of loans since 1981.

During the past year, we have moved over $500 million to assist the Federal intermediate credit banks in Spokane and Omaha.

For over 3 years, we have taken significant steps in consolidating management, streamlining the staffs, putting loss sharing agreements in place in individual districts, and providing for the consolidation of capital to deal with the financial difficulties we are faced with.

In attachment A, we provide a list of those self-help programs which we have implemented.

Fourth, we understand and support the need for a regulator with the same powers and authorities of the other Federal financial institutions. We proposed regulatory changes and that is in our attachment C to the testimony.

While I will be pleased to answer your questions concerning our proposal, I would prefer to speak directly to the question of why does the Farm Credit System require financial assistance this year.

There are three major reasons. First, to ensure that U.S. agriculture continues to have adequate and reasonably priced credit.

Second, to ensure that the agency market on which the housing industry as well as agriculture is heavily dependent to insure that it remains strong.

Third, to prevent a disastrous blow to the domestic economy.

Mr. Chairman, we are not a depository institution like a thrift or commercial bank, but we are, nevertheless, trying to prevent a run on the Farm Credit System. Because the Farm Credit System generates funds through the issuance of agency securities, a critical question is whether we can ultimately obtain funds at any price. Without strong investor confidence, the market for our securities will shrink.

Three weeks ago the Farm Credit System issued its third-quarter financial report. In that report, it showed the losses for the third quarter were $522 million. For the 9 months ending September 30, the losses were $426 million. This is the first reported loss for the Farm Credit System since the Depression.

In that report, nonaccrual loans increased to over $3.5 billion, almost double that amount reflected on June 30, 1985.

As a result of the growing amount of nonaccrual loans on the Farm Credit banks' books, I am convinced that a substantial increase in our allowance for loan losses standing at $1.1 billion will be required before year end. We have reported that we project the level of nonearning assets, the nonaccrual loans to increase between now and the end of 1987 to $10 billion or more.

With this level of nonaccrual assets, it means that the banks and associations of the Farm Credit System would be forced to minimize losses and the erosion of capital. That would mean the acceleration of the collection of delinquent loans, increases in interest rates to cover the cost of carrying those nonaccrual loans, aggressively marketing the inventory properties involved in those foreclosures, and press forward with widespread consolidations of associations, to protect the members' capital.

Our borrower-stockholders and their cooperatives will have good reason to question the reliability of the Farm Credit System as a source of credit at reasonable rates.

If Congress and this administration cannot agree on some mechanism to provide financial assistance to the Farm Credit System this year, we will not be providing reasonably priced credit as we are asked to do under our mandate from Congress.

A second major reason for our seeking assistance is to maintain the sponsored agency. Certainly while the market would survive a collapse of the Farm Credit System, it would incur major costs in the process. Sponsored agencies would pay these costs because of the loss of their implicit Government guarantee as well as the rise in overall interest rates. In short, agencies would no longer represent their quality that they have over the years.

Our third and final point is preventing a disastrous blow to the economy due to default by the Farm Credit System. We commissioned Chase Econometrics to do a study, and they have reported back to us. I have made the executive summary of that study available to you as attachment D to the testimony. The Chase study shows an impact on the domestic economy more in the order of a tidal wave than a ripple, and I would encourage your study of page 4 of the executive summary. It speaks to additional loans being foreclosed, increased interest rates in the agricultural sector. It speaks to a shortfall of agricultural credit in the magnitude of $22 to $29 billion. It suggests that agricultural banks through rural America would lose over one-third of their capital as they are a major investor in farm credit securities. As a whole, the Nation's banking industry would be affected.

Secondary impacts in interest rates, economic growth, mortgage rates, the jobs and Federal deficit are also shown in that report. We believe that shocks to the economy of the nature being estimated in this study can be prevented, with explicit reassurance in the form of government financial assistance to the Farm Credit System.

We have two problems. First, we need to stabilize the market for system obligations and insure the continued flow of capital to farmers through the Farm Credit System; and second, we need assistance in carrying the burden of the nonaccrual loans through the transition that agriculture is experiencing to deal with the problems that are being felt in the rural economy.

We want to be able to do that without forcing substantial increases in interest rates. The Farm Credit Administration, the banking system's regulator, has indicated without financial assistance, at least 40 production credit associations would be liquidated or forced to consolidate by early 1986. Some 30 more may be in as serious a difficulty. They suggest as many as three Federal intermediate credit banks and two Federal land banks will meet the same fate within a year. These are not just small banking institutions in isolated cities, but combined assets of hundreds of thousands of farmers in many States.

Mr. Chairman, we believe it is imperative that the steps be taken in this session of Congress to restore the confidence of both the investor and the farmer in the Farm Credit System.

We do not see any way in which we can absorb multibillion-dollar losses for the next 2 or 3 years and carry the massive levels of nonearning assets, keep the confidence of the investing community and keep the faith of our best farmer and cooperative borrower stockholders.

I thank you, and I am prepared to answer any questions that the committee might have.

[The prepared statement of Mr. Sims with attachments follow:]

THE FARM CREDIT COUNCIL
1800 MASSACHUSETTS AVE, NW · WASHINGTON, DC 20036 · 202/466-4180

Statement by

Douglas D. Sims, President

St. Louis Bank For Cooperatives

Before the

House Banking Committee

Subcommittee on Economic Stabilization

November 13, 1985

Mr. Chairman:

My name is Doug Sims. I am President of the St. Louis Bank for Cooperatives. I am appearing here today as a member of The Farm Credit Council's Legislative Committee.

The Council was formed in 1982 and is the federated national association of borrower-owned farm lending institutions across the country, including all 37 of the nation's Farm Credit Banks and over 90 percent of all Production Credit and Federal Land Bank Associations.

Mr. Chairman, the banks and associations that make up the Farm Credit System are directed, by law, to serve the credit and financial service needs of U.S. agriculture. The System's institutions are farmer-owned and farmer-directed organizations, totally dedicated to obtaining funds from the nation's money markets and lending those funds on a reasonable and dependable basis to U.S. farmers, ranchers and their cooperatives.

The Farm Credit System provides nearly one-third of the total credit to agriculture, and about half of the long-term credit for farm real estate. In size, the Farm Credit System is roughly equal to the third largest bank in the United States.

Nearly two weeks ago, Mr. Chairman, we appeared before the House Agriculture Committee's Subcommittee on Conservation, Credit and Rural Development, requesting a $6 billion line of credit from the Treasury to help the Farm Credit System and its one million farmer borrower-owners survive one of the worst depressions ever in agriculture.

We did this knowing there would be criticism, but with the firm belief that not seeking help now would result in the imminent collapse of the Farm Credit System.

Before I proceed, I think it is important to review some of the most frequently asked questions about our request:

o First and foremost, we're not asking for a grant, only for a loan to be repaid, just as the System has done in the past, as it returns to profitability.

o Second, we are seeking assistance only for the Farm Credit System. This does not mean commercial banks and other financial institutions should be excluded from assistance. Indeed, the vehicle we have designed is a financial warehouse which can be adapted for other institutions. However, we can speak only for the Farm Credit System about specific need, the commitment of our resources and the repayment of a loan.

o Third, the System has taken many steps to help itself, including $4 billion in loan chargeoffs since 1981, $500 million in inter-district help to the Omaha and Spokane Federal Intermediate Credit Banks in 1985 and consolidation of district bank management, thus reducing staff costs and benefits by $60 million per year. We've also entered into Loss-Sharing and Capital Preservation Agreements which provide significant self-help assistance. **Attachment A** elaborates on these steps.

o Fourth, we believe that our proposal for assistance--as outlined in Attachment B--will significantly contribute to a soft-landing for still falling farmland values, and stem further erosion in agriculture's asset base. This benefits all agriculture, including all other institutions which have agricultural loans in their portfolios.

o Fifth, the System-wide obligations which fund the operations of the Farm Credit System are the joint and several obligations of the 37 Farm Credit Banks. The banks and associations which make up the Farm Credit System are a group of farmer-owned and farmer-directed, locally based farm lending cooperatives knit together by a common charter Act, a common regulator and their co-responsibility on obligations issued through a common funding source.

o Sixth, we understand and support the need for a regulator with the same powers and authorities as the other Federal financial institution regulators, no more and certainly no less. A summary of regulatory changes which we have proposed is **Attachment C**.

o Seventh, with respect to accounting practices, the System operates in conformance with GAAP, except to the extent that regulations of the Farm Credit Administration have required us to deviate from GAAP accounting. While a number of System banks have been audited by "big eight" firms for several years, Price Waterhouse will audit the consolidated statements of the 37 Farm Credit Banks for 1985.

While I will be pleased to answer specific questions about our proposal, I prefer to speak directly to the question: Why does the Farm Credit System require financial assistance this year?

There are three major reasons:

o The first is to ensure that U.S. agriculture continues to have adequate and reasonably-priced credit. This will not happen unless the System enjoys the confidence of its investors and owner-borrowers. And I want to stress that our customers and owners are one and the same.

o The second is to ensure that the agency market--on which the housing industry, as well as agriculture, is heavily dependent--remains strong. If the Farm Credit System is allowed to fail, the entire agency market will be severely impaired and considerably larger Federal expenditures will be necessary to maintain that market. Already the housing agencies are feeling the effects of investor concerns about the soundness of Farm Credit's agency securities.

o The third is to prevent a disastrous blow to the domestic economy. The Chase Econometrics study, which we commissild to examine the impacts of a System default, draws some very ominous conclusions.

Let me get right to the first issue. Members of this Subcommittee are thoroughly familiar with the base causes for and the results of a run on a financial institution. It comes about because of a loss of confidence by depositors--their investors--and results in a liquidity crisis.

You are familiar with what is happening in the agricultural sector of our economy. It is being torn apart by large supplies, declining exports, deflation and some of the highest real interest rates in history. These factors resulted in one of the steepest drops in land values in history, and land is the principal collateral for our loans.

Mr. Chairman, we're not a depository institution like a thrift or commercial bank, but we are nevertheless trying to prevent a "run" on the Farm Credit System. We are walking a financial tightrope held by the capital markets on one end and farmer-borrower-stockholders on the other.

Because the System generates loanable funds through the issuance of agency securities--about $70 billion a year--a critical question is whether we can ultimately obtain funds at any price. As you know, our cost of funds has gone up 100 basis points since the end of July. We have lost many traditional investors, but others, willing to take more risk for a higher rate of return have replaced them. They remain convinced that the Federal government will not deny the Farm Credit System the assistance it needs.

However, without strong investor confidence, the market for our securities shrinks. Before the Farm Credit System began to experience problems, we were able to market a full range of securities in the size and amounts desired. We often had two to three times as many buyers as we needed. A month ago, the coverage on a six-month issue was only 1.4 to 1!

Mr. Chairman, on December 2, 1985, we have $3.3 billion in bonds maturing. By the end of this calendar year, at least $7.6 billion in discount notes will mature, and this will likely increase, given the 5 - 30 day maturities. On January 2, 1986, we have an additional $1.9 billion in bonds maturing.

Institutional buyers with conservative investment guidelines, for instance trust funds, cannot continue to justify purchases of System securities.

In a very short period of time, Farm Credit securities have gone from being an investment on the highest order to being described by an article in the October 28th Washington Post as "junk bonds." Standard and Poors, the corporate rating agency, is currently assessing whether the System's securities should continue to be approved as an investment for AAA-rated corporations.

A major factor in their assessment is our financial reports to investors. Three weeks ago, the Farm Credit System issued its Third Quarter Financial Report. This report has also been made available to the Committee and I would like to simply highlight it:

o Losses for the quarter totaled $522 million and $426 million for the nine-month period ended September 30th.

o Non-accrual loans increased to $3.5 billion or almost 5 percent of loans outstanding, nearly double the amount reported on June 30, 1985.

o The provision for losses was increased nine-fold to $675.9 million for the first nine months of 1985, compared to $77.4 million for the same period last year, primarily because of the nationwide credit review of the land banks portfolios. This review indicated that approximately $6 billion of the total of $48 billion in outstanding land bank loans are undercollateralized by almost $1 billion.

o Based on the special credit review and other macro-economic studies, the Farm Credit Banks may be exposed to loan losses aggregating $3 billion or more during the next three years (1985-87).

o A substantial increase will be required to the allowance for loan losses--now $1.1 billion--based on a further analysis of a bank-by-bank analysis of the loss exposure in each Bank's loan portfolio.

I would like to take a moment to walk through the financial projections which we have made to arrive at the amount of assistance which we believe is needed. We've already reported that the level of non-earning assets between now and the end of 1987 may be $10 billion or more.

USDA's data shows that as of January 1985, farmers leveraged greater than 40 percent, who also had negative cash flows in 1984, owed the System $18.7 billion. Those in the most immediate trouble--having both a debt/asset ratio of greater than 70 percent and negative cash flow--owed the System $8.6 billion. A total of $3.5 billion in System loans is owed by farmers with debt-to-asset ratios over 100 percent, farmers who are technically insolvent.

Newly released USDA data shows that the same farmers who owe the System $18.6 billion also owe an additional $6 billion to other lending institutions!

At year-end 1984, the 37 Farm Credit Banks, together with the Production Credit and Federal Land Bank Associations, had total risk funds--capital and loss reserves--of $13.1 billion with non-accrual assets of $2.5 billion. By September 30, 1985, risk funds had dropped to $12.8 billion and non-accrual assets had jumped to $3.5 billion. By the end of 1985, we project that non-accrual assets can reach at least $6 billion.

If loans in non-accrual status reach $11 billion in the next two years, the System's risk funds will fall to $6.9 billion. Of that $6.9 billion, however, $4.9 billion is farmer and cooperative-invested stock. In other words, if all the surplus and loss reserves of the 37 banks and nearly 700 associations were combined into one account, the System would have to net more than $9 billion in recoveries on $11 billion in non-accrual loans to avoid the impairment of farmer-borrower stock throughout the System.

This means that System banks and associations would be forced to minimize losses and the erosion of capital. They would:

o Accelerate the collection of delinquent loans to minimize the burden on non-earning assets.

o Increase interest rates to borrowers to cover the higher costs of purchased money and the carrying costs of non-accrual loans and acquired property.

o Aggressively market inventoried properties, placing further downward pressure on already distressed farm real estate markets.

o Press forward with widespread consolidations of associations to most efficiently utilize capital remaining within the System.

Our borrower-stockholders and their cooperatives will have good reason to question the reliability of the Farm Credit System as a source of credit at reasonable rates. But it doesn't end there. When we lose their business, we also lose their capital investment, which in total is almost $5 billion.

If Congress and this Administration cannot agree on some mechanism to provide financial assistance to the Farm Credit System this year. We will not be providing reasonably-priced credit, and the already taut tightrope begins to unravel or snaps!

A second major reason for seeking assistance is to maintain the sponsored agency market. There is a close relationship among sponsored agencies like FannieMae, GinnieMae, Freddie Mac, and the other "agency" issues. Traditionally, as costs or problems for one increase, the others have followed.

While this market would certainly survive a collapse of the Farm Credit System, it would incur major costs in the process. Sponsored agencies would pay these costs because of the loss of their implicit government guarantee as well as the rise in overall interest rates. In short, "agencies" will no longer represent quality and there will be a flight away from "agencies" to quality.

Our third and final point is presenting a disastrous blow to the economy through the default by the Farm Credit System. This is a scenario which we sincerely hope never occurs. Candidly, some have suggested that the Farm Credit System has outlived its usefulness and should be allowed to fail.

We listened to that statement, heard several people agree with it and decided that it was important to try to quantify what a collapse by the Farm Credit System would actually mean. We commissioned Chase Econometrics to do this study and they have reported back to us. I have made the Executive Summary of this study Attachment D to our testimony and also taken the liberty of providing the Committee's staff with a complete copy of the report.

In short, the Chase study shows an impact on the domestic economy, more on the order of a tidal wave than a ripple. I think the chart on page 4 of the Executive Summary graphically details this.

As a direct result of a System default, an additional 88,000 farm operators nation-wide would have their loans foreclosed, and interest rates paid by farmers who do continue would increase by 3 1/2 - 4 1/2 percentage points in the first year, as a result of default. Further, there will be an estimated $22 - 29 billion shortfall in credit to meet agricultural production expenses.

Because of their holdings of Farm Credit securities, the 3,900 agricultural banks throughout rural America would lose over one-third of their capital. Agricultural banks with less than 7 percent capital would increase from 150 today to 2,300, driving a higher number toward failure! As a whole, the nation's banking industry would lose close to 10 percent of its capital in the first year and would experience additional losses as other agricultural loans fail.

Secondary economic impacts are no less dramatic:

-- interest rates outside agriculture would increase by 2 1/2 - 3 percentage points, resulting in slower economic growth.

-- real GNP is reduced by $32.3 billion in the first year after default, and $44.3 billion in the second year, or approximately two percent in each year,

-- Higher mortgage rates, together with slower income and job growth lead to a loss of over one million housing starts in the first two years, a decline of over 30 percent from the projected baseline,

-- an estimated 1.5 million jobs would be lost,

-- the Federal deficit would increase by $53 billion.

Shocks to the economy of the nature being estimated in this study can be prevented with explicit reassurance in the form of government financial assistance. The first requirement is to stabilize the market for System obligations. This will ensure the continued flow of capital to farmers through the Farm Credit System, while it reduces System funding costs and prevents significant and devastating increases to farmers' interest rates.

We have considered the usefulness of Federal guarantees on System securities and concluded that it is only a partial solution. While some may be concerned strictly with Wall Street and the investing public, this does not solve the critical financial problems of farmers and their Farm Credit System. Only assistance in carrying the cost of non-accrual loans ensures that the System will have the capital necessary to permit restructuring of nonperforming loans, holding liquidated property off the market or absorbing significant loan losses without forcing substantial increases in interest rates!

This underscores the unique role and responsibility of the Farm Credit System to U.S. agriculture. As single industry lenders, totally dependent upon a still deteriorating farm economy, the banks and associations of the Farm Credit System are being squeezed between rising costs of funding and increasing levels of non-accrual assets. System institutions have no choice but to raise interest rates to farmers--a substantial portion of whom cannot pay present rates. This further aggravates the financial plight of those who cannot refinance and drives away those who can. As interest rates increase, the System's capital and earnings base erode. As the institution feeds on itself, the investors demand ever higher rates until they finally stop purchasing System securities.

The Farm Credit Administration has indicated that without financial assistance:

- At least ~~10~~ 30 production credit associations will be liquidated or forced to consolidate by early 1986,

- As many as three Federal Intermediate Credit Banks and two Federal Land Banks will meet the same fate within a year. These are not simply five institutions in five cities. They represent the combined assets of hundreds of thousands of farmers in many states.

Absent a collapse of the bond market, the financial problems facing the system would not bring the System crashing down all at once. As the amount of reserves available for System self-help, through the triggering of loss-sharing agreements, are drained, individual institutions will fail. Their sister institutions will assume responsibility for their debt obligations. In this scenario, at an accelerating place, the System will fail, association by association, and bank by bank.

We believe it is imperative that steps be taken in this session of the Congress to restore both investor and farmer confidence in the Farm Credit System.

Mr. Chairman, we do not see any way in which we can absorb multi-billion dollar losses for the next two or three years AND carry massive levels of nonearning assets AND keep the confidence of the investing community AND keep the faith of our best farmer and cooperative borrower-stockholders!

Attachment A

Farm Credit System Self-Help Actions
To Ensure System Financial Viability

District Actions:

1. Loss-sharing agreements were entered into among PCAs. These agreements were to take effect only after an association had used its own loss reserves, current income and usually 10 percent of its surplus. Associations were not asked to impair farmer-borrowers' stock. Since 1982, 75 percent of the districts' PCAs have triggered loss-sharing agreements.

2. District banks have provided financial assistance under agreements entered into between a specific association and its supervising bank. This mechanism was to be used only if local resources and intra-district association loss-sharing could not maintain the viability of the local association. In the case of PCAs, help came in the form of an investment from the Federal Intermediate Credit Banks, either by the purchase of non-accrual assets--primarily non-accrual loans and acquired property--or by the direct infusion of capital. All twelve district FICBs made some such investments in local PCAs, amounting to more than $181 million at June 30, 1985. Subsequent to June 30th, the Omaha FICB had invested about $120 million in its PCAs, $75 million of which was financed by other district banks.

Inter-District Actions:

3. If the financial stress within a district were such that the viability of a district bank were in jeopardy, inter-district capital preservation agreements would be activated. The troubled banks were required to look first to their sister banks within their districts for assistance, and then, in recognition of the joint and several liability of the 37 Banks on all System-wide obligations, to all System banks. These agreements have been in place since the late 1970's.

4. To supplement capital preservation agreements among the districts, special inter-district assistance programs were developed and applied for the first time in 1985, to assist the Spokane and Omaha Federal Intermediate Credit Banks. To help those two banks alone, the other banks of the System committed a total of $476 million--$136 million for the Spokane FICB and $340 million for the Omaha FICB.

5. To facilitate and to administer inter-district assistance plans, the 37 Farm Credit Banks chartered and capitalized the Farm Credit System Capital Corporation -- headquartered in Wichita, Kansas -- specifically to acquire--on behalf of all 37 banks--the non-accrual assets of troubled banks in Omaha and Spokane.

System-wide Operating Efficiencies:

6. To better protect the farmer-borrower's stock investment, to cut costs and achieve operating and organizational efficiencies, a number of districts have developed--and some have implemented--proposals to pool the capital of PCAs within the district through consolidations of associations into single, district-wide organizations, or through expanded district loss-sharing programs. To date, seven of the twelve districts' farmer boards of directors of PCAs have approved such proposals. In two districts, those proposals have already won the required stockholder approvals and are now being implemented. In three districts, FLBA boards of directors have voted to form a district-wide FLBA. One of those proposals has been presented for and has received stockholder approval. And, I think it's important to note, Mr. Chairman, that in every instance, these votes have been by very decisive margins, which we would be pleased to provide to the Committee.

7. In recent years the districts made substantial progress in establishing single Farm Credit service centers in communities which have both a PCA and Federal Land Bank Association. These actions have already resulted in elimination of duplicate facilities, reduced overhead and improved coordination in the extension of credit to our farmer stockholders.

8. We've consolidated the management of the district banks--the Banks for Cooperatives, the Federal Intermediate Credit Banks and the Federal Land Banks. Of ten districts which now have consolidated management for the three district banks, eight of those consolidations have occurred since 1982. Again, the result is more effective use of executive talent, reduced overhead and improved coordination in credit programs and services.

9. The System has made massive staff reductions. In 1985, we will have reduced System-wide employment by 10%--over 1,700 people--to an estimated 15,600 by the end of this year. Some district banks have suffered staff cut-backs of 30 percent. This represents a cost savings of approximately $60 million per year.

10. Apart from these issues, the System banks and associations have recognized their losses. Between 1982 and 1984, charge-offs totalled $4 billion. This year alone, we expect charge-offs among System banks and associations to exceed another $1 billion.

Attachment B

Proposal for Government Assistance

1. Establish a financial warehouse for non-accrual loans and acquired property in the Farm Credit System Capital Corporation to be funded jointly by the System and the U.S. Government.

2. As a condition of receiving Federal financial assistance, authorize the Capital Corporation to mobilize available System capital through assessments on System institutions, consistent with standards to be established by the Farm Credit Administration (FCA). To protect farmers in contributing districts from undue interest rate increases, assessments could not exceed one-half of one percent of interest-accruing assets in any fiscal year.

3. To help defray the costs of carrying non-accrual loans and acquired property and to provide other financicial assistance, authorize creation of a $6 billion line of credit from the U.S. Treasury to be drawn upon through the Farm Credit Administration in amounts of no more than $2 billion in any fiscal year.

4. Provide for district self-help by requiring an institution to draw upon the financial resources of the other institutions in its district, in order to be eligible for assistance from other System institutions.

5. Provide for continued local loan administration, including restructuring or workout of troubled loans, related assets and acquired property.

6. Require FCA to set regulatory guidelines for loan restructuring and property management taking into account such things as local farm real estate market conditions, production value of real estate collateral, conditions under which foreclosed property may be leased back to qualified borrowers, terms under which System institutions will secure the amount of any deferred principal through participation in future appreciation of collateral or other means. Such guidelines would be implemented in policies of the Capital Corporation and would apply in districts which receive inter-district or government assistance.

7. Government funds would be repaid through assessments by the Capital Corporation as System institutions are able to repay, consistent with regulatory standards established by FCA.

8. Require, consistent with conditions of prior Federal assistance to the System, the payment of annual fees equal to the Government's cost of funds or 25 percent of System earnings, whichever is the lesser, for so long as such loans are outstanding.

9. Authorize FCA to increase legal debt-to-capital limits for PCAs to 20 to 1, thus avoiding many otherwise necessary liquidations of troubled PCAs.

10. Assure the safety and soundness of the public's investment by granting enhanced regulatory powers for the Farm Credit Administration, coupled with a withdrawal of the agency from participation in System business and policy decisions.

Attachment C

SUMMARY
FARM CREDIT ADMINISTRATION IMPROVEMENT ACT OF 1985

I. PURPOSE

- To establish the Farm Credit Administration as an effective, arms-length regulator of the Farm Credit System institutions by:
  - Restructuring the Farm Credit Administration;
  - Providing such restructured Farm Credit Administration with enforcement powers comparable to those enjoyed by the FDIC and other federal financial institution regulatory agencies; and
  - Separating the Farm Credit System institutions from their arms-length regulator, the Farm Credit Administration, by:

    (i) removing from the FCA most of the prior approval authorities now vested in the FCA, which involve the FCA in day-to-day management decisions of the Farm Credit System institutions, and are deemed inappropriate for an arms-length regulator;

    (ii) deleting those enumerated powers of the FCA, as set out in Section 5.18 of the Act, which are managerial in nature and are likewise inappropriate for exercise by an arms-length regulator; and

    (iii) repealing the existing authority of the FCA to delegate its functions and duties to the very Farm Credit System institutions it is charged with regulating.

II. PROPOSAL

A. Restructuring of the Farm Credit Administration

The proposed bill would restructure the Farm Credit Administration to foster its independence from the regulated Farm Credit System institutions. Under current law, the FCA operates under the direction of a thirteen member Federal Farm Credit Board, twelve of whom are appointed by the President with the consent of the Senate from a list of nominees proposed by the System institutions and one of whom is designated by the Secretary of Agriculture. The Board appoints the Governor who acts as the chief executive officer of the FCA. Under the proposed restructuring, the FCA would be managed by a full-time, three-member Farm Credit Administration Board, which would be appointed by the President with the advice and consent of the Senate for staggered six-year terms. The President would also appoint a Chairman of the Board, who would serve as the FCA's chief executive officer. The Federal Farm Credit Board, now the policy-making arm of the FCA, would become an advisory committee appointed by the Chairman of the new Farm Credit Administration Board, which would provide information on, and make recommendations to the Board with respect to, matters within the jurisdiction of the Farm Credit Administration Board, but would itself have no policymaking or managerial role.

B. Enforcement Powers

The proposed bill would provide the restructured FCA with enforcement powers comparable to those given to the FDIC and other federal financial institution regulatory agencies. These include, most importantly, (i) the power to issue cease and desist orders, both permanent and temporary, (ii) the power to remove and suspend directors and officers of Farm Credit System institutions, and to replace on a temporary basis directors who have been suspended or removed where all of the directors of a particular Farm Credit System institution have been suspended or removed; and (iii) the power to assess civil penalties for violations of final cease and desist orders.

C. Removal of Prior Approval Authorities

Partly as a result of the existing prior approval authorities contained in the Farm Credit Act, the FCA has become enmeshed in the day-to-day management of System institutions. This, in turn, makes it difficult for it to function effectively as a true arms-length regulator. The proposed bill would eliminate most of these existing prior approval authorities, and either (i) make the subject matter of those authorities subject to regulations promulgated by the FCA; or (ii) return the decisionmaking as to such subject matter to the individual System institutions where it appropriately belongs. Thus, for example, borrower interest rates, which are currently subject to prior approval by the

FCA would henceforth be governed by regulations promulgated by the FCA. The same would apply to the regulation of permissible investments by System institutions. Other prior approval authorities, including those relating to loss sharing agreements, and determinations as to the basis for patronage refunds, would be deleted entirely and the authority to make decisions concerning such topics returned to the boards of directors of the individual System institutions.

D. Removal of Delegation Authority

Under current legislative authority, the Farm Credit Administration is empowered to delegate its duties and functions to the Farm Credit System institutions. The exercise of such authority serves further to blur the distinction between the regulator (the FCA) and the regulated (the System institutions), and is totally inappropriate for an arms-length regulator. Accordingly, this power has been deleted in the proposed bill and conforming changes have been made to other sections of the bill referring to such delegated authority.

E. Amendment of Enumerated Powers

Many of the enumerated powers of the Farm Credit Administration set out in Section 5.18 of the Farm Credit Act are managerial, rather than regulatory, in nature, and are not appropriately exercised by an arms-length regulator. These powers have accordingly been deleted in the proposed bill. However, the proposed bill also adds a new power, which empowers the FCA, as the System institutions' regulator, to regulate the preparation and dissemination of information on the financial condition and operations of System institutions. The proposed bill also incorporates an amendment recommended by the FCA concerning modifications to its existing examination authority.

November 5, 1985
The Farm Credit Council
466-4180

Attachment C

ECONOMIC IMPACTS OF A FARM CREDIT SYSTEM DEFAULT

a report to

The Farm Credit Council
Washington, D.C.

by

Chase Econometrics
Bala Cynwyd, Pennsylvania 19004

October 29, 1985

ECONOMIC IMPACTS OF A FARM CREDIT SYSTEM DEFAULT

SUMMARY

At the request of the Farm Credit Council, Chase Econometrics analyzed and measured the implications of a default by the Farm Credit System (FCS) on major affected parties, such as the financial markets, farmers, the Federal Government and the U.S. economy at large. Although a default by the FCS is not expected to occur, the dire situation in the farm economy has sufficiently weakened the FCS to lead the Farm Credit System to request federal assistance. Thus, in an effort to provide information to policy decision makers, it is appropriate to analyze the impact of a default by the FCS on its securities during 1986.

The current problems in the Farm Credit System, brought on by a deep depression in agriculture, come at a particularly critical time. The U.S. economy has grown very slowly since mid-1984; only scattered signs of improvement have appeared. The U.S. financial system is also under stress. Bank failures are at their highest levels since the 1930s; problems abound with foreign debt, mortgage defaults, securities losses, and loan losses. A default by the Farm Credit System in 1986 on $70 billion of securities, with no rescue by the Federal Government, would be massive and unexpected. This unprecedented default would further depress agriculture, severely disrupt financial markets, and seriously weaken an already fragile U.S. economy. This study concludes that a default by the Farm Credit System under the economic conditions of 1986 will cause: loans to an additional 88,000 farmers to be foreclosed, commercial bank capital to drop by $28 billion; the number of agricultural banks with inadequate capital to rise to 2,300 from 141 currently; the nation's gross national product to lose $32 billion in year one and $44 billion in the second year and the deficit to rise by $32 billion in the first year and $53 billion in the second year.

A. MAJOR CONCLUSIONS:

A FCS default exacerbates problems of banks and financial institutions:

- The widely held expectation that the Federal Government would effect a rescue in this crisis, or any other, is shattered as holders of the FCS's $70 billion in securities sustain losses of $28 billion. These losses surge through the financial system adversely affecting banks, securities dealers, insurance companies and others. Mortgage markets are disrupted as the agency status of FNMA, FHLMC and FHLBS is largely removed.
- Commercial banks lose $14 billion on FCS securities default, reducing the banking industry's capital by about 10%. Subsequent losses on farm loans would generate $4.2 billion of additional losses in the first two years. These losses occur at a time when many banks already have inadequate capital ratios[1] and when bank failures are at their highest levels since the 1930s.
- The 3,900 agricultural banks lose $3.7 billion, over a third of their capital, as losses on FCS securities early in the default scenario are followed by farm loan losses during the subsequent two years.
- The number of agricultural banks with inadequate capital rises from 141 at present to 2,300 by 1987 (year two) as their average capital/asset ratio declines from 10.5% currently to 7.0% by 1987; failures among these banks increase significantly in year one and continue at a high rate in year two.

A FCS default directly affects the farm sector:

- An estimated 88,300 additional operators (5.2%) will have their loans foreclosed in the first year.
- These operators hold $55.4 billion in farm business assets (10% of the total) and $36.7 billion of farm business debt, 30.5% of the total.
- Of the $36.7 billion in operator debt which is under foreclosure, $21.6 billion is held by the Farm Credit System and $15.1 billion is held by other agricultural lenders. This other-lender debt figure of $15.1 billion is equivalent to 19.2% of the total farm operator debt outstanding held by lenders other than the FCS. Commercial banks would be holding $6.5 billion of these foreclosed loans.
- Interest rates paid by farmers are expected to rise 350 to 450 basis points in year one under this scenario—a rise that could cost farm operators as much as $4.5 to $5.9 billion. Interest rates paid by farmers would rise sharply with this event due to: (a) a reduced supply of credit to agriculture, (b) removal of a unique funding source for agricultural capital needs, (c) the increase in the risk associated with agricultural loans due to new and intensified downward pressures on farm asset values, and (d) the large increase in interest rates throughout the economy due to the financial market disruptions.

Less than 7%.

- The default will leave approximately one fourth of agricultural input purchases exposed, as agricultural credit becomes both expensive and scarce. A FCS default creates a shortage in the short-term production input credit market of $22 to $29 billion, equivalent to 23% to 30% of total farm input cash purchases. Thus, it is necessary for operators to cut back on input purchases, fund purchases from currently weak cash flow or turn to alternative sources of credit such as input suppliers.
- Farm land prices fall 40% from current levels, with one-half of this decline (20%) as the direct result of the FCS default.

Financial market and farm sector implications combined have major effects upon the U.S. economy (1986 is year one):[2]

- The perceived greater risk of holding U.S. financial assets drives private interest rates up by an average of 250-300 basis points and drives down the value of the dollar up by 5% in the first year. The mortgage commitment rate averages 15.5%, up from 12.6% in the CE baseline forecast.
- Higher interest rates, compounded by a loss in confidence, depress business investment. The loss in real fixed nonresidential investment is nearly $85 billion over the five-year period, with $12.2 billion lost during the first year alone.
- The fall in investment induces slower growth in output, employment and income. Real disposable income is lowered by $8.7 billion in year one and $14.3 billion in year two. A total of nearly 1.5 million jobs is lost by the second year. By the fifth year, employment remains 560,000 below the level in the baseline forecast. Real GNP is reduced by $32.3 billion in year one and $44.3 billion in year two, or approximately 2% in each year.
- Higher mortgage rates, together with slower income and job growth, lead to a loss of over one million housing starts in the first two years, a decline of over 30% from the projected baseline.
- Lower employment, a smaller income base, and increased transfer payments increase the Federal deficit to $265 billion in the second year, $53 billion higher than in the 1987 baseline forecast.

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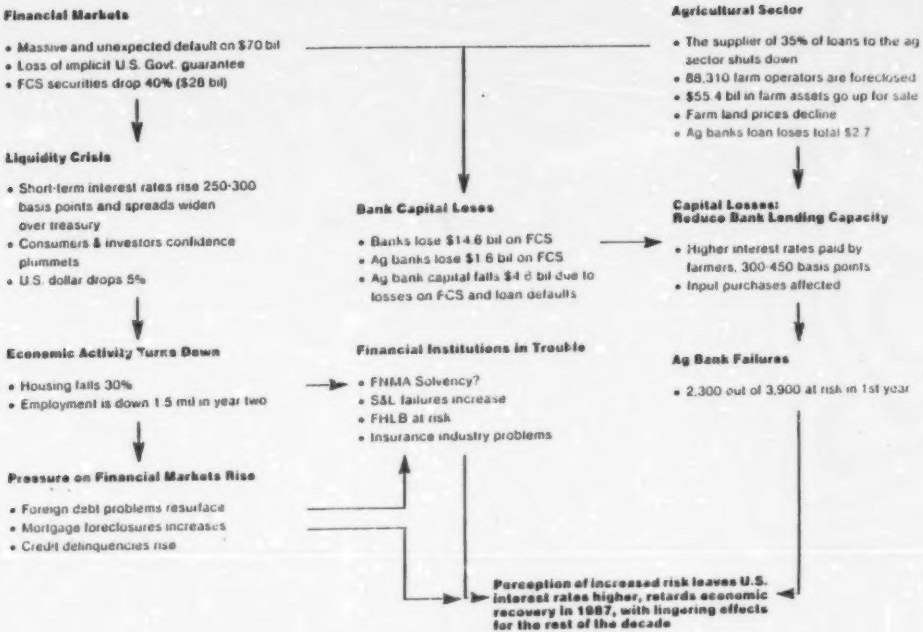
[2] All macroeconomic impacts are relative to the Chase Econometrics baseline forecast of the U.S. Economy. Impact estimates were also made based upon the Administration's economic outlook. See body of this report for details.

FCS Default: Overview



Financial Markets

- Massive and unexpected default on $70 bil
- Loss of implicit U.S. Govt. guarantee
- FCS securities drop 40% ($28 bil)

Liquidity Crisis

- Short-term interest rates rise 250-300 basis points and spreads widen over treasury
- Consumers & investors confidence plummets
- U.S. dollar drops 5%

Economic Activity Turns Down

- Housing falls 30%
- Employment is down 1.5 mil in year two

Pressure on Financial Markets Rise

- Foreign debt problems resurface
- Mortgage foreclosures increases
- Credit delinquencies rise

Bank Capital Loses

- Banks lose $14.6 bil on FCS
- Ag banks lose $1.6 bil on FCS
- Ag bank capital falls $4.6 bil due to losses on FCS and loan defaults

Financial Institutions in Trouble

- FNMA Solvency?
- S&L failures increase
- FHLB at risk
- Insurance industry problems

Agricultural Sector

- The supplier of 35% of loans to the ag sector shuts down
- 88,310 farm operators are foreclosed
- $55.4 bil in farm assets go up for sale
- Farm land prices decline
- Ag banks loan loses total $2.7

**Capital Losses:
Reduce Bank Lending Capacity**

- Higher interest rates paid by farmers, 300-450 basis points
- Input purchases affected

Ag Bank Failures

- 2,300 out of 3,900 at risk in 1st year

Perception of increased risk leaves U.S. interest rates higher, retards economic recovery in 1987, with lingering effects for the rest of the decade

Table 1
Summary of Economic Impacts of a Farm Credit System Default[a]

	First Two Years
Bank Capital	
All Banks	-10%
Agricultural Banks	-33%
Ag Banks with Inadequate Capital	2,300 (59% of total)
Farm Foreclosures	
Number of Operators	88,300 (5.2% of Total)
Value of Assets Involved	$55.4 bil (10.1% of Total)
Value of Debt Involved	$36.7 bil (30.5% of Total)
Farm Land Prices[b]	-20% in Year One

	Year 1	Year 2	Year 3	Year 4	Year 5
Interest Rates, Percentage Points					
Treasury Bill Rate	+0.87	+0.46	+0.12	+0.10	+0.03
Commercial Paper Rate, 3-mo	+2.77	+2.32	+1.86	+1.35	+0.94
Mortgage Rate	+2.94	+2.78	+1.51	+1.34	+0.79
GNP					
Bil 1972$	-32.3	-44.3	-24.8	-17.2	-12.0
% Impact	-1.9%	-2.5%	-1.3%	-0.9%	-0.6%
Housing Starts					
Thousand Units	-550	-510	-10	-50	20
% Impact	-34.4	-31.1	-0.5	-2.7	+1.1
Federal Deficit Deterioration, bil $	32.0	53.1	41.1	34.6	28.4
Jobs, thousands	-580	-1,460	-1,380	-840	-560

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[a] Based upon default occurring 1-1-86.
[b] Northern Plains and Cornbelt.

B. SUMMARY DISCUSSION

Introduction

The objective of this study is to analyze and measure the implications of a default by the Farm Credit System (FCS) for major affected parties, such as the financial markets, farmers, the Federal Government and the U.S. economy at large. Although a default by the FCS is not expected to occur, the dire situation in the farm economy has sufficiently weakened the FCS to lead the Farm Credit System to request federal assistance. Thus, in an effort to provide information to policy decision makers, it is appropriate to analyze the implications of a FCS default.

FCS's default, defined as its inability to meet its security payment obligations, means it cannot raise new capital funds and must cease lending. This default would have major implications, not only for U.S. farmers and bankers, but also for the health and growth of the U.S. economy. The analysis assumes that a FCS default occurs unexpectedly in early 1986, with no organized rescue.

The Federal Reserve is assumed not to engage in extensive purchases of FCS securities. It responds to the liquidity crisis and subsequent financial problems by supplying increases in reserves to the banking system. Because of the Federal Reserve's long-term goal of controlling the growth in the money supply, however, we are assuming the Federal Reserve does not fully offset the impact of the default on financial markets. In the absence of an organized rescue, the Fed is unable to effect an orderly response to the financial crisis, as in previous failures of major financial institutions, because the default's impact is so large and spreads immediately throughout the financial system.

Critical to the role which the FCS occupies in the U.S. economy, beyond its sheer size (about the same size as the third largest U.S. bank) is its implicit "government guarantee" which has characterized the FCS since its beginning. This implicit guarantee is clearly violated with a FCS default scenario and, logically, so is the implicit government guarantee of other sponsored agencies such as FNMA, FHLB and FHLMC. The function of the FCS as a unique source of capital for financing the inherently unique risks of agriculture obviously ceases in this scenario as well. In the FCS, the Production Credit Associations (PCAs) and the Federal Land Banks (FLBs), have extended capital to 312,000 and 653,000 farmers, respectively, in addition to $8.9 billion in loan volume outstanding to farm and rural utility cooperatives through the Banks for

Cooperatives (BCs). On average, U.S. farm operators in debt to the FCS have 67¢ of debt outstanding to other lenders for every $1.00 of debt owed the FCS[3]. Thus, as a reliable and effective source of capital to U.S. agriculture, the FCS plays an integral role in the U.S. farm economy, making an FCS default a far-reaching upheaval.

A financial default of the magnitude of the FCS in the United States is unprecedented; thus, a quantitative analysis of such an event requires utilization of a mixture of quantifiable economic relationships, economic theory and previous experiences. Chase Econometrics (CE) drew upon a team of staff professionals in financial market analysis, agricultural economic analysis and macroeconomic analysis, together with CE econometric models, to estimate the implications of this event, its magnitude, as well as some specific impacts which can be identified with a high degree of confidence. These results represent our analysis and best judgments of the implications of a FCS default.

In order to estimate the magnitude and duration of the effects on the U.S. economy, a special simulation of the Chase Econometrics long-term macroeconomic model was compared to a baseline forecast for the period from 1986 to 1990. The simulation included a rise in private interest rates averaging 250-300 basis points and a 5% decline in the trade-weighted value of the dollar in 1986. In addition, it was assumed that a loss of confidence would have further adverse effects on capital spending, beyond the direct impact of higher interest rates.

Summary Analysis

For well over a year, the U.S. economy has grown very slowly, beset by a large trade imbalance, a large and rising Federal deficit, and serious strains in both the domestic and international financial systems. A major shock to the economy, of the magnitude of a collapse in the FCS and the spillover effects on the rest of the financial system, can be expected to have an especially grave impact in view of these underlying problems. The very fragility of the financial markets and the weakness in the economy suggests, in fact, that a FCS collapse may well have even more adverse effects than those described in this analysis.

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[3] Other lenders include commercial banks, individuals, Farmers Home Administration, merchants, the Commodity Credit Corporation and others.

Table 2. Estimated Impact on Agricultural Bank Capital Ratios of the FCS Default and Subsequent Loan Losses[a]

		Number of Agricultural Banks less than 7% Capital Ratio		Percent of Agricultural Banks less than 7% Capital Ratio	
	Total	Before	After	Before	After
Alabama	25	1	10	4	40
Arkansas	45	0	14	0	31
California	4	1	2	25	50
Colorado	68	3	36	4	53
Florida	6	0	2	0	33
Georgia	56	0	16	0	29
Idaho	12	2	8	17	67
Illinois	399	14	226	35	57
Indiana	88	4	48	5	55
Iowa	522	23	350	4	67
Kansas	418	21	284	5	68
Kentucky	82	2	37	2	45
Louisiana	21	1	10	5	48
Maryland	3	0	1	0	33
Massachusetts	1	0	0	0	0
Michigan	19	2	15	11	79
Minnesota	392	4	254	1	65
Mississippi	30	4	13	13	43
Missouri	284	12	179	4	63
Montana	74	4	43	5	58
Nebraska	390	9	239	2	61
New Mexico	6	0	4	0	67
New York	3	0	0	0	0
North Carolina	3	0	0	0	0
North Dakota	134	3	91	2	68
Ohio	54	4	21	7	39
Oklahoma	157	10	87	6	55
Oregon	5	2	3	40	40
Pennsylvania	2	0	0	0	0
South Carolina	2	0	1	0	50
South Dakota	127	2	74	2	58
Tennessee	37	2	19	5	51
Texas	201	7	88	3	44
Utah	3	0	0	0	0
Virginia	4	1	2	25	50
Washington	15	1	7	7	47
West Virginia	1	0	0	0	0
Wisconsin	190	2	109	1	57
Wyoming	24	0	9	0	38
Total	3,907	141	2,302	4	59

[a] Based upon March 31, 1985

A FCS Default is Massive and Unexpected for the Financial Markets. With about $70 billion in securities outstanding, FCS is about the same size as the third largest U.S. bank, or three times the size of the largest S&L. It is equivalent to about a tenth of S&L deposits, or a third of outstanding commercial paper, or almost all of the credit union industry. Studies of previous corporate bond and other defaults indicate that the value of defaulted securities can be expected to decline by as much as 60% from par following default. Given the characteristics of the collateral backing FCS debt, the value of FCS securities is projected to fall by 40% from par upon default. Holders of FCS securities would experience a loss of $28 billion. This one default would dwarf the $5.2 billion total of corporate bonds defaulted on between 1970 and 1984.

A default by FCS is not only large but also unexpected. Although spreads have widened between U.S. Treasury rates and FCS rates, the financial markets continue to believe there will be Federal assistance. In combination, the size and speed of the financial crisis results in extreme liquidity pressures. The financial markets quickly realize the full implications of the default. Initially the burden of the FCS default falls on FCS security holders, but the rapid rise in rates also threatens other financial institutions, particularly banks and thrifts. The Federal Reserve responds to the liquidity pressures by supplying additional reserves to the banking system, but permits rates to rise because of its long-term goal of controlling the growth in the money supply. The sheer size of the default and widespread impact on financial institutions prevents the Federal Reserve from engineering the sterilized increase in reserves that it would typically undertake in the event of the failure of a major financial institutions, such as Continental Illinois.

The number of agricultural banks with inadequate capital (capital/asset ratio of less than 7%) rises to 957—the number was 141 on March 31, 1985—due solely to the 40% decline in FCS security values because FCS securities are an important part of agricultural bank portfolios. Farm loan losses compound securities losses, increasing the number of agricultural banks with inadequate capital by 1,345, to a total of 2,302, equal to 59% of all agricultural banks in the United States. The number of agricultural banks with inadequate capital was estimated on a state basis as well. Table 2 presents the preliminary results of this analysis.

The other sponsored agencies face significantly higher borrowing costs not only because of the loss of their implicit federal government guarantee, but also because of the rise in interest rates. FNMA's solvency is now in question, because its cost of funds is rising faster than the yield on its large portfolio of mortgages. The FHLB system is threatened by the prospect of widespread solvency problems and increased failures among its member savings institutions.

FHLMC is better protected by its financial structure than the other agencies, but is still threatened by the rising tide of mortgage foreclosures and the weakness in the mortgage insurance industry's financial condition. The loss of support from these agencies, the earnings problems of S&Ls and the increased risk of default raises mortgage rates by 290 basis points in 1986.

The liquidity crisis is compounded by a flight to quality. Demand for U.S. Treasury securities increases relative to the demand for private sector securities. The T-bill rate thus rises to only 8.5% in 1986 as compared to the federal funds rate average of 10.8%. The yield curve becomes steeper to reflect the increased risks of long-term investment. Investors now perceive the U.S. government to be largely unwilling to take steps to ensure an orderly transition when a crisis occurs in U.S. financial markets. The dollar declines to reflect investors' perception that U.S. securities are now riskier relative to other countries' securities. This default is occurring fast on the heels of various noticeable solvency problems among banks, thrifts, insurance companies and securities dealers.

Higher interest rates and slower economic activity in 1986 generate additional problems for financial institutions. Higher interest rates and rising unemployment, arriving at a time when households' debt burden is already high, result in an increased pace of mortgage foreclosures and consumer credit delinquencies. Households become less willing to take on new debt. The banking system is once again threatened by foreign debt defaults as higher interest rates and weakness in the U.S. economy cause payment problems for LDC borrowers. Losses on agricultural loans exacerbate the problems of agricultural banks, and hence their correspondent banks, leading to an increased number of agricultural bank failures. Together, these second round effects, coming at a time of economic weakness in the financial structure of the economy, maintain the upward pressure on interest rates in 1987 despite the weakening of the economy.

For the U.S. economy at large, the immediate effects of a FCS default are a rise in private interest rates and a decline in the value of the dollar. The massive disruptions in financial markets and liquidity problems described above, erode business and household confidence, with damaging effects on capital spending which reaches beyond the direct impact of higher interest rates. Business fixed investment is depressed with the loss in real investment over the period from 1986 to 1990, totaling $84.4 billion, 7% below the "no-default" scenario.

The result of a lower level of fixed investment is weaker growth in output, employment, and income. Relative to current expectations, real GNP will fall by 1.9% in 1986, and 2.6% in 1987 due to a FCS default. Thus, real GNP will grow by 0.7% and 2.7% in 1986 and 1987, respectively compared to increases of 2.6% and 3.3% in the CE baseline forecast. As the initial effects of the financial crisis dissipate, the economy returns to a trend growth rate of 3% by 1990, but from a new, lower starting point. Even at the end of the decade, employment, real income, and investment remain below the level reached in the baseline forecast. The loss of investment is likely to have further consequences in the decade which follows since slower growth in the capital stock and the slower rate of incorporation of new technology will retard productivity growth, a major determinant of real incomes.

Weaker capital spending leads to slower employment growth, with the unemployment rate reaching 7.8% in 1986 and remaining at that level in 1987, well above the 7.3% and 7% rates of the baseline scenario. Even with economic recovery in the latter years of the decade, employment remains nearly 600,000 lower than in the baseline forecast (see **Table 3** for a year-by-year comparison of the Chase Econometrics baseline forecast and the FCS default).

Slower job growth, and the impact of weaker economic activity overall, reduces income growth, with further effects on personal consumption expenditures. Real disposable income in the Farm Credit System default scenario is 0.7% and 1.1% below baseline expectations in 1986 and 1987, respectively. Real personal consumption expenditures, particularly for new cars, is similarly depressed, rising about 0.6 percentage points below the growth rates of the baseline forecast.

The U.S. housing sector is particularly hard hit by a FCS default. Higher mortgage rates, liquidity problems in the secondary mortgage market, together with slower job and income growth, weaken housing demand during the five-year forecast horizon. Relative to the baseline, more than one million housing starts are lost in 1986 and 1987. Although housing demand partially recovers from 1988 on, there is a net loss in the nation's housing stock as a result of the financial crisis.

Table 3
Impact of Farm Credit Default on U.S. Economy: Default vs. Baseline Scenario
(billions of 1972 dollars, except as noted)

	1986	1987	1988	1989	1990
Loss in GNP	$32.3	$44.3	$24.8	$17.2	$12.0
Loss in Fixed Investment	$12.2	$16.9	$18.3	$18.9	$18.1
Loss in Personal Consumption	$ 6.2	$13.0	$13.3	$ 9.5	$ 7.4
Loss in Disposable Income	$ 8.7	$14.3	$ 7.8	$ 4.2	$ 4.1
Percentage Loss in Industrial Production	3.8%	4.6%	0%	1.9%	0%
Loss in Housing Starts, (thousands of units)	550	510	10	50	(20)
Jobs Lost (thousands)	580	1,460	1,380	340	560
Federal Deficit Deterioration (bil nominal $)	$32.0	$53.1	$41.1	$34.6	$28.4

The Federal deficit, already a major drain on the economy, worsens with a FCS default, reflecting lower employment, a smaller income base, and increased transfer payments. In the Farm Credit System default scenario, the deficit peaks at $265 billion in 1987, $53 billion higher than in the baseline forecast and remains higher through the decade.

In the farm economy, a failure of the FCS immediately translates into reduced supplies of capital and increased farm foreclosures. Capital is critical to this industry with seasonal input purchases and cash flow. The U.S. farm economy is currently on the edge of financial disaster, and the sector can ill afford to suffer a dramatic reduction in credit availability. Negative cash flow, falling farm real estate values, high debt-to-asset ratios, and low return on equity are characteristic of the difficult situation in the farm economy today. Nationwide, 20% of farm proprietors' equity has been lost during the past four years. Equity losses have been much more dramatic in key agricultural areas where land prices have fallen approximately 40%. The drop in farm land values, both a cause and an effect of the farm financial crisis, has reached its most rapid pace since 1933. Farm cash flow, which averaged $40.5 billion per year during 1978 to 1982, has averaged only $32.4 billion during the past two years. With the FCS default, capital supplies available to farming will be reduced and negative cash flow becomes a critical consideration. Fifty percent of U.S. farm operators have a negative cash flow; these operations hold 49% of U.S. farm operator assets.[4]

With the sudden disappearance of FCS credit, other lenders will be hard pressed and to fill the void. Loan volume of other lenders has to expand by 25% to completely make up the gap left by FCS, an expansion that would not be feasible under the circumstances which will exist with a FCS default: (a) Additional loan losses of $2.9 billion sustained by commercial banks from farm foreclosures resulting from the FCS default (equal to 8.5% of commercial bank loans outstanding to farm operators), (b) a $1.7 billion loss in the capital value of agricultural banks as FCS securities fall to 60% of par value, (c) a farm economy which is already performing poorly, (d) expectations by the general public and investors that agricultural returns will be poor, making it difficult and expensive for other agricultural lenders to acquire additional capital, (e) an acceleration in the rate of decline in farm real estate values, and (f) new market uncertainties in the wake of a FCS default.

As the agricultural capital markets attempt to adjust to this reduced supply, many farmers with a negative cash flow will be unable to secure production loans and will be forced out of business. Loans outstanding to an additional 88,300 farm operators (5.2% of total operators) will be foreclosed as the direct result of a FCS default. The mass foreclosures will throw $55.4 billion in farm operator assets onto an already falling real estate market. This amount is equivalent to 10% of the total value of operator assets. The farm foreclosures will be on $36.7 billion in farm debt, 30.5% of the total farm operator debt outstanding. Of this debt, $21.6 billion is FCS debt, while $15.1 billion is owed to other lenders, of which an estimated $6.5 billion is held by commercial banks, **Table 4.**

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[4] The farm financial data used in this report is believed to be the most reliable information available, which comes from the Farm Cost and Returns Survey (FCRS) conducted by the Economic Research Service of the USDA. The FCRS was conducted in the spring of 1985 and reports data for calendar year 1984 and January 1, 1985. This survey included "farm operators" only and developed the following national totals: number of farms, 1.694 million; farm operator debt for business purposes, $120.2 billion and farm operator assets, $548.9 billion. As such, these data report smaller values than other USDA estimates for differing definitions of all farms which included the following national totals: number of farms, 2,186 thousand; total farm debt including households, $212.5 billion and total farm assets including households of $955.8 billion. Thus, it should be noted that the analysis in this report is based upon the lowest estimates available on the farm debt situation. The use of other, higher estimates of farm debt would show even greater impacts. See body of report for further explanation of data sources.

Table 4
Summary Impact of Farm Credit System Default on Farm Foreclosures

	Impact on Foreclosures Due to FCS Default	Impact on Foreclosures as % of Total
Number of Operators	88,310	5.2
Value of Assets, bil $	55.4	10.1
Value of Debt:		
Total, bil $	36.7	30.5
FCS	21.6	51.6
Other Lenders	15.1	19.3
Commercial Banks	6.5	19.3

It is believed that these estimates of farm foreclosures do not overstate the impact, and are likely to understate the severity of the outcome for two reasons. First, these estimates measure foreclosures that are expected to occur "directly" as the result of the FCS default. As discussed below, an ensuing downward spiral in the price of farm land will most likely be triggered by the large block ($55 billion) of farm assets forced onto the market. The foreclosure estimates do not include the increase in foreclosures expected to result from the triggered downward spiral in land prices. Second, the data utilized here include "farm operators" only and exclude landlords. Thus, all of the above foreclosure estimates would increase if "all farms" rather than all "farm operators" were included. Conservative expansions to include landlords would raise the assets foreclosed upon from $55 billion to $75 billion and debt foreclosed upon from $36.7 billion to $40.8 billion.

Additionally, farm input purchases and distribution will be impacted by the BC's default. This study did not analyze the effect upon U.S. farm cooperatives of a default by the BCs. However, the BCs have $8.9 billion in loans outstanding to farm cooperatives, and hold approximately 51% of the total debt owed by the 100 largest cooperatives. As integral members of the farm sector, U.S. farm cooperatives are facing financial stress together with their farmer-member-owners. Thus, cooperatives will face new financial risks and farmers stand to lose still further asset value with an erosion in cooperative share values (currently 3% of total farm asset value).

The default of the FCS has a dramatic impact on already depressed farm land values, especially in the Northern Plains and Corn Belt states—the heart of American agriculture. Short-run expectations of capital gains are already small or nonexistent in farm real estate markets. With a default by the FCS, resulting in a major reduction in available capital and a shock of 10% of farm operator assets going onto an already depressed market, expectations of capital gains would become zero, or negative. Thus, current and projected returns from farming would be the deciding factor for prospective buyers and market dynamics would be such that farm land would have to be able to cash flow.[5]

A default by the FCS and the resulting farm foreclosures will force wheat land in the Northern Plains down $102/acre (22%) to $357/acre, **Table 5.** Corn and soybean land in the Corn Belt states is projected to drop $576/acre to $670/acre or 46% below current levels. The average drop in dry cropland prices in the two areas combined would be 40%, double the anticipated 20% drop in farm land prices already expected in 1986.

Table 5
Impact of Farm Credit System Default on Dry Cropland Prices in Northern Plains and Corn Belt States

Region	Current Price	Estimated Default Price	Change $/ac	Change %
Northern Plains	$459	$357	-102	-22
Corn Belt	1,246	670	-576	-46
Weighted Average[a]	871	521	-35	-40

[a] Weighted by crop

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[5] Cash cost includes an annual cost for operating capital.

Although not presented here as a likely scenario, a combination of events can be envisioned that would cause farm land prices to fall even further. As the financial community becomes pessimistic about the future of U.S. agriculture and as the supply of land for sale in the real estate market becomes burdensome, land prices could fall below cash flow value levels. Shocks to the farm real estate market that place even greater downward pressure on land prices, such as a FCS default, could make the downward spiral in land prices a self-perpetuating mechanism. That is, increased foreclosures place more land on the market and push land prices still lower, adding to loan losses at agricultural banks, increasing foreclosures and thus placing still more land on the market.

Interest rates charged to farmers will rise 300 to 450 basis points with FCS default. Interest rates throughout the economy will rise due to the many financial market implications. Rates charged to farmers will rise this amount plus further increases due to some unique circumstances in agricultural credit markets, which include: (a) a sharply reduced supply of agricultural credit due to removal of the FCS, additional bank loan losses and FCS security losses; (b) the removal of an effective means of funding agricultural credit through the aggregation of small denomination loans made in rural areas into large denomination bonds sold on Wall Street, and (c) the increased risk associated with agricultural loans due to new and intensified downward pressures on farm land values.

Under this scenario, approximately one-fourth of farm input supply sales is in jeopardy. There is a void left in the farm short-term production loan market of $22 to $29 billion. (These figures refer to annual credit extended, rather than debt oustanding at a particular point in time.) The shortage of short-term production credit is equivalent to 23% to 30% of total farm cash expenditures excluding interest expenses. As outlined above, commercial lending institutions will be unable to fill this credit gap. Thus, with agricultural credit both very expensive and very scarce, input purchases would have to be reduced or new sources of credit for input purchases would have to be found.

In summary, the already weakened farm economy will suffer a major setback as agricultural credit tightens, interest rates rise, and a large block of farm foreclosures pushes additional land on an already depressed real estate market. Additionally, as a consequence, farm input suppliers will be faced with losing sales or extending credit to a weakening sector.

Chairman LaFalce. Thank you very much, Mr. Sims.

The administration has proposed, while they are considering the need for financial assistance, and preliminary to the consideration by the Congress of the question of financial assistance, that there should be first and foremost prompt legislative action on (a) reorganization of the Farm Credit System, and (b) greater supervisory authority given to the Farm Credit Administration.

Do you have any problem either with the reorganization that they seek, or the greater supervisory authority that they seek, depending upon a question of the nexus that should or should not exist between that and financial assistance?

Mr. Sims. Mr. Chairman, if I understand the administration's testimony, it is speaking to the reorganization of the regulator, the Farm Credit Administration, which we endorse and support, and is not speaking specifically to the reorganization of the Farm Credit System.

Chairman LaFalce. Mr. Sethness.

Mr. Sethness. We would have included in our legislative proposals a number of things, including the establishment of an entity internal to the Farm Credit System that has authorities to do things that the system currently does not have in the way of mobilizing of capital and assessing the operating units.

Chairman LaFalce. Yor are referring to the Farm Credit Capital Corporation?

Mr. Sethness. Yes. We think it would be a relatively major restructuring step for the Farm Credit System.

Mr. Sims. We support in statutory language the formation of this capital corporation which would both assess capital within the System as well as administer the Government assistance.

Chairman LaFalce. So that means you would have some centralized system of surplus and reserves that could be used; is that correct?

Mr. Sims. That is correct.

Chairman LaFalce. Is there uniformity within the system regarding that approach? Do the stronger regions believe that they should be called upon to assist the weaker regions?

Mr. Sims. Yes, I believe there is unanimity within the system. There is concern, Mr. Chairman, among the stronger banks as to the amount of help and support that they can give and still maintain a viable, reasonable operation for their farmer borrowers, at the same time helping the other banks in the System.

Chairman LaFalce. You have no problem, either, do you, with giving greater supervisory authority to the Farm Credit Administration?

Mr. Sims. No, we do not. We have proposed regulatory reform consistent with that.

Chairman LaFalce. There is basically no problem on both those scores and should be able to proceed legislatively, and I would think rather promptly. I would think that should be in and of itself sufficient so that the bond market should be able to reduce the spread that exists even more than it has in the past week. I certainly hope that is the case.

Now, the position of the administration is, once that legislative step is done, we can consider later the question of financial assistance if deemed necessary, and that they would be studying the question of financial assistance between now and whatever time they would then come to the Congress.

I would assume you would have a problem with that, Mr. Sims. They don't think there is that imminent a need for a legislative consideration on the merits, because of the retained surplus and loss reserves that exist, which I think they feel are sufficient to enable the system to get by for at least a year or 18 months or more. Second, they believe, politically, that requesting financial assistance, whether $3 billion or $6 billion or more, whatever amount, would so slow up the legislative process, that it would have a dilatory effect on the bond market. Have I fairly characterized the administration's position, Mr. Naylor, Mr. Sethness?

Mr. SETHNESS. Yes.

Mr. NAYLOR. I believe you generally have. We have indicated our willingness to assess an additional Federal role when we have some consensus within the Congress on the direction of the first two steps, but we do believe those should be moved promptly.

Chairman LAFALCE. Good. All right. I would ask you to respond to (a) the substantive, and (b) the political perspective.

Mr. SIMS. Basically, we believe that the problem we are dealing with is larger than the resources of the Farm Credit System, and therefore these two moves alone, without financial assistance, will not give the investor confidence that we have the ability to deal with the problem. That assumes that the investor would be willing to look at a Farm Credit System experiencing multibillion-dollar losses in 2 or 3 years, without the explicit backing of the Federal Government, and continue to provide investment funds to the System for use in our operations.

Chairman LAFALCE. Mr. Sims, do you have Mr. Sethness' testimony before you?

Mr. SIMS. No, I do not.

Chairman LAFALCE. Please turn to page 8. When you look at those figures that Mr. Sethness has presented, and you compare the income and projected losses, and you look at the surplus, total capital, loan loss reserves, why wouldn't that be adequate? Mr. Sethness, I believe it is your position that it might well be adequate, and certainly ought to calm the fears of the bond market?

Mr. SIMS. I have a couple of charts with me, if you would indulge me.

Chairman LAFALCE. You don't want to say that the fears of the bond market should not be calmed?

Mr. SIMS. As well as the farmers, and if I could utilize those, Mr. Chairman. I would like to share with you graphically what is basically shown here in numbers. It outlines our decline in risk funds through 1987, and then a second chart that shows our buildup in nonaccrual loans. That basically says that in 1987, the chart on the right shows total risk funds, and it shows the green, which is the capital stock owned by farmers, ranchers and their cooperatives in the Farm Credit System. The blue is the earned surplus that has been built up over 50 years. The red is the reserve for losses, of our total risk funds. These charts depict what we project to happen out through December 1987, and you will see it projects $400 million of earned surplus with reserves of $1.6 billion to protect the investment of farmers and their cooperatives.

The chart on your right shows the buildup of the nonaccrual loans on the balance sheet of the Farm Credit System, and shows that by 1987 our nonaccrual loans will be 159 percent of the total risk funds. That is what the investor would be looking at in terms of the type of asset problems we have on our balance sheet. At the same time, it would be showing multibillion-dollar losses, which are not shown on page 8 here of Mr. Sethness' testimony.

Mr. SETHNESS. The losses are in fact shown in that first column.

Chairman LAFALCE. I wonder, Mr. Naylor or Mr. Sethness, do you have any comment on that data?

Mr. SETHNESS. We have no basic quarrel as to what the numbers are. The comment on the total risk funds chart on the left there is that it still seems quite inconsistent to us to be asking for taxpayers to put their money in before what is labeled "risk funds" have been in fact put fully at risk. There is still earned surplus there, still loan loss reserves available. The nonaccrual assets that are on the books of the institutions by the end of 1987 have been fully reserved against to reflect the expected losses that are going to occur from them and over some period of time will be turned back into earning assets again.

Chairman LAFALCE. Then you would have a quarrel with applying what they refer to as the nonearning loan assets as a percentage of total risk funds; is that correct?

Mr. SETHNESS. The chart is simply a ratio of two numbers. It is the conclusions one would draw from the chart that we might quarrel with.

Chairman LAFALCE. That is what I want to focus in on. What conclusion is Mr. Sims drawing that you are taking issue with?

Mr. SETHNESS. My understanding of where Mr. Sims and I would take issue is whether farmers would remain comfortable with the security of their stock, and whether bond market investors would continue to buy debt securities of an entity that showed numbers like these at the end of 1987.

I believe that given what I expect to happen to the System in 1988, which is that these things start to improve, that both of those groups that need to be reassured would in fact stay reassured through that period.

Chairman LAFALCE. I don't want to ask many more questions because the other members want their opportunities.

I am curious, if we use the same type of charts with other Government-sponsored entities, although not Government-insured or Government-backed, whether the situation might look as dire in charts as this situation looks.

Mr. SIMS. Mr. Chairman, I might suggest that the Treasury analysis of this portfolio assumes that we have a clean loan portfolio at 1987, and that we return to profitability, even though we have got this amount of nonaccrual loans on our books. Second, it assumes only $70 million of provision for losses as opposed to the $1.5 billion in the previous 2 or 3 years. It assumes a stable agriculture industry from 1988 on, and it presumes funding at favorable rates with continuing losses.

I think you focused in very clearly on where we probably have differences of opinion about the conclusions of these numbers.

Chairman LAFALCE. What is the administration's opinion now on Mr. Sims' comments?

Mr. NAYLOR. Mr. Chairman, it is our view that the System is in the process of changing its basic accounting procedures and methods for recognizing prospective losses. It is in the process of taking a series of steps to set aside loss reserves of approximately $6 billion over the next several years, which are adequate to fully service the nonaccrual prospective losses which may—and I emphasize—occur by the time the problems are fully worked through, over a period of years.

Once the System has fully resolved its problem loan situation, it can in 1988, begin to move back to a positive position. It will not have expended its full surplus nor impinged upon borrower stock, which is invested by the borrowers.

Under those conditions—and it does assume continued access at reasonable spreads to the marketplace—the System has very considerable capacity to solve the problem itself, using its own funds which were set aside for that purpose. It does assume some very significant problems in the general economy over the next several years, and that we begin to see the recovery we anticipate in 1988 and beyond. It assumes a strengthening of the economy as we work through the basic transition that is occurring in that industry.

I think it is important to note that in either case, we are basing the assumptions on projections of what may be, not what is, and that we are setting aside, or the System is proposing to set aside, substantial reserves in anticipation of a serious potential problem with their loans. Indeed, we are talking about $13 billion in potential problem loans, approximately $11 billion of which may still be on the books as late as 1987.

Mr. SETHNESS. I would like to add to that and repeat something that I said earlier. The nonaccrual loans that will then be on the balance sheet—creating the ratio of the big rising column on Mr. Sims' chart—will have been reserved against and the losses expected on those assets will already have come out of earnings and surplus. We don't have to take a loss for a bad asset twice. We have already established the loan loss reserve for it.

Chairman LAFALCE. Thank you.

Mr. Shumway.

Mr. SHUMWAY. Thank you, Mr. Chairman.

I think your questions were very much the same as many of my questions. I am intrigued by the fact that we can have such disparate opinions on this subject. It would seem to me that somehow the factual setting could be boiled down to something very objective and certainly we could take different policy directions from those facts. However, it seems we are not at that objective place yet. We are still talking about how much the debt is and how much the assets are. It seems to me before we talk about remedies we should first get to that objective point.

I appreciate the fact that when there is an ill patient, different physicians can prescribe different medicines based upon the same symptoms, but I think it would be rare physicians could be as widely apart in their opinions as to prescribe medical surgery on one hand or taking of some kind of medicine on the other hand.

In any event, I would like to pursue a couple of points that the chairman hit upon in his questioning.

Mr. Sims, you made it very clear that you believe that financial help, and said this year, is necessary. I think you cited three basic reasons for that opinion having to do with credit and the economy. Mr. Sethness, you made it quite clear in your statement there is definitely no need for financial assistance now and it would be a mistake to grant it given the need for prompt legislative action.

Mr. Sethness and Mr. Naylor, you are saying that we should give more tools for self-help, for better organization, for creation of this capital corporation.

Mr. Sims, your testimony was remarkable in that you didn't address these things and yet you have told us how you have exercised some degree of help.

Have you felt that your hands have been tied in any respect in terms of using your own assets and mobilizing your own resources to apply on this problem?

Mr. SIMS. No, sir. I have been involved in both assistance packages in Spokane and Omaha. In both cases, unanimously the banks of the System agreed to put up the capital necessary even in front of the loss sharing and capital preservation agreements that already exist within the System.

There was quite a bit of debate among the banks as to how much assistance was needed and how big the problem was, but when it got down to the bottom line that money was there for both the FICB of Spokane and Omaha. However, we have proposed in our legislation the statutory ability of that capital corporation to assess the banks of the System, to do that same program for other banks as it may be necessary during the coming year and thereafter.

Mr. SHUMWAY. But you don't see, as I take it, these structural changes as being an immediate solution or that high a priority; at least I didn't see that in your statement. Is that correct?

Mr. SIMS. We have two problems we are trying to deal with. One is the financial markets problem and that is immediately upon us. The second one is the financial problem of the Farm Credit System that we are protecting that is out in front of us and the Government assistance is necessary, in our opinion, to show a strong signal——

Mr. SHUMWAY. Government assistance outside of structural change?

Mr. SIMS. Yes, to show a strong signal that the Government is standing behind the Farm Credit System through the loan that we have asked for. Then, second, the financial program does take some structural change in order to warehouse the bad loans and assess the banks through the self-help program. We are supportive of that to the point that the banks that are giving loans continue to be able to provide reasonable and sound credit to their farmers and cooperatives.

Mr. SHUMWAY. Mr. Sethness, everybody that has spoken about this problem brings to our attention over and over again the fact that something must be done this year and I think even you conceded that it does have some immediate impacts that need to be addressed right away. If the capital corporation is created by legislation, if we proceed to make those structural changes as I call them, how would that help to alleviate the problem this year so that, come next year, there will be money on hand and sufficient confidence that the program could go forward? Do you see those structural changes as being sufficient remedy now to keep them on their feet?

Mr. SETHNESS. Yes. I think that this is not a cash need problem as long as the markets stay open to the Farm Credit System at a reasonable interest cost. And it is my conclusion that the markets will remain open to the Farm Credit System if they perceive that the Congress and the administration are sufficiently concerned about the survival of the entity that we put in place two fairly major sets of restructurings to get them to be able to more effectively exercise self-help.

Mr. SHUMWAY. So that is primarily designed to handle any scare at the market and the System would handle itself?

Mr. SETHNESS. The System, I believe, has the financial resources to handle itself. It is an amazingly well capitalized financial institution.

Mr. SHUMWAY. In your statement, you talked about these problems and you said the unfortunate result has been increased pressure on farm borrower stockholders in the System. Every proposal that I have seen always exempts the borrower stock and these charts would confirm that. No one has come here and said we should invade that stock equity.

Mr. SETHNESS. We don't think you even need to.

Mr. SHUMWAY. Why would stockholders feel that they are going to be penalized in the process of somehow resolving this problem?

Mr. SETHNESS. If I could refer that to Mr. Naylor.

Mr. NAYLOR. The problem boils down to this: While the System has made major efforts in self-help internally, including working out support actions for the Omaha and Spokane districts, the fact is that it has had great difficulty in marshaling the substantial surpluses that it has around the country. As a result, in areas like Iowa and Nebraska when an association has a significant number of problem loans and has exhausted its own resources, there has been substantial pressure to move to do one or all of three actions: Either increase the interest rates to the better borrowers, engage in precipitous and aggressive liquidation policies, or to freeze or hold member stock.

This has caused a very strong reaction within those individual areas, raising considerable fear among individual member borrowers, whose money is at risk, about their ability to continue with that particular lender.

One of the problems we see here, I think, is the highly decentralized nature of the decisionmaking process within the System. While solutions have been developed for Omaha and Spokane, there have been numerous private and public statements that there is a growing concern and perhaps resistance, to moving further without some specific legislative authority to do so, in the form of a capital corporation which could pool the System's considerable resources.

Some say that, had those resources been pooled effectively, used efficiently and not dissipated, many of the problems being experienced today might have been avoided in part or in full. That inability to move promptly has had a severe effect on the System's ability to ward off some of the problems the System has already experienced.

Mr. **SHUMWAY**. Thank you, Mr. Chairman.

Chairman **LAFALCE**. Mr. Torres.

Mr. **TORRES**. Thank you, Mr. Chairman.

Mr. Sethness, in his statement, stated that there has to be some basic reforms taking place. One of those that he emphasized most succinctly was that the Farm Credit Administration must be reorganized and reformed so that it will operate as an independent regulator of the System. Mr. Sims said that he understood that and he supports the need for a regulator with the same powers and authorities as the other Federal financial institutions.

My question is to Mr. Sims. How does the current supervisory or regulatory powers of the FCA differ from those of the FDIC or the Office of the Comptroller?

Mr. **SIMS**. I believe the large difference is in their intermediate enforcement powers, but one must recognize that the Farm Administration the way it has been structured in the past has been a regulator, an auditor, and in some regards an operational policymaker for the System, and we believe that has been inappropriate.

The main difference though is in the intermediate enforcement powers and cease-and-desist authorities and actions such as that.

Mr. **TORRES**. Just to follow up if the FCA already had such powers as an independent regulator how much difference do you think that will have made to the recent Farm Credit System performance or would it have made a difference?

Mr. **SIMS**. I understand they will be here tomorrow and I would encourage you to ask them that question. My opinion is that the problem we are dealing with is a farm income problem that is now backed up into the basic assets that the lenders are financing, and our problem that we have defined here in the charts is largely as a result of some 50 to 60 percent decline in land values largely in the row crop areas of the Midwest and I believe neither the farm income or devaluation of farm assets are issues that a regulator can control.

Mr. **TORRES**. Thank you, sir.

Mr. Chairman, I have no further questions. I yield back the balance of my time.

Chairman **LAFALCE**. Thank you.

Mr. Wortley.

Mr. **WORTLEY**. There is an old adage something about figures lie and liars figure. There are incredible discrepancies between your figures, Mr. Sethness, and the Farm Credit System's report here. To quote specifically, you say the Farm Credit System's capital totaled $1.08 billion and according to your third quarter report, you show the Farm Credit System, and there are 37 farm credit banks combined, they are showing a total capital of $8.5 billion. That is a difference of approximately 25 percent between the two figures.

You also indicate, Mr. Sethness, a $5.5 billion earned surplus, whereas the Farm Credit System, according to their printed report, shows $3.6 billion. These are rather substantial gaps.

Can you two gentlemen resolve this for us so we could work from the same base?

Mr. SETHNESS. This one is fairly easy to resolve and there isn't a difference between us. The third quarter statement is a consolidation only of the 37 farm credit banks. The numbers that are in my testimony and the numbers that Mr. Sims has on the chart there reflect the consolidation of those 37 banks and all of the local associations, the PCA's and the land bank associations, and at the land bank associations and the PCA's, there is another $1.9 billion worth of earned surplus.

Mr. WORTLEY. OK. Now, if the Farm Credit System, you are talking about trying to tap the U.S. Treasury for about $6 billion, you are already sitting on, at least according to Mr. Sethness's figures, $5.5 billion of your own earned surplus.

Why do you have the earned surplus if you are not going to put it to some use? You say the $6 billion that you are talking about tapping the Treasury for is something that you are going to use over a period of years, not something you are going to need between now and December 21, right?

Mr. SIMS. That is correct.

Mr. WORTLEY. Why do you have to tap the Treasury if you have $5.5 billion of surplus?

Mr. SIMS. We will be utilizing that surplus as we write those loans down, and we expect to be utilizing at least $2 billion of that surplus probably before the end of this year.

The purpose for the loan that we are requesting is to utilize, to finance, the cost of carrying those nonaccrual loans so that we can manage through the transition in agriculture and not have the land price plummet below their true economic cash-flow value as a result of too much land on the market at one time.

Mr. WORTLEY. Now, if you are asking for $6 billion, what are you doing in the meantime to straighten up your own house?

Mr. SIMS. We have done a number of things. First of all, we have put together the loss sharing and capital preservation agreements that will be utilized to protect against stock impairment in the System as individual banks experience losses and writeoffs from these loans.

Second, we have been making major changes to streamline the management of the banks, consolidating management of the three banks in individual districts.

We are in the process of reducing the number of employees. That number has resulted in savings of approximately $60 million. Third, we are encouraging local PCA and land bank associations to consolidate their capital so that they can more readily absorb the risk in the exposure in those areas.

Just this past week, in St. Louis, the PCA's voted overwhelmingly to merge their capital to do that, and to reduce the number of local service centers.

Those are the kinds of steps that we are taking in addition to the movement of capital to the other districts that I have already mentioned, which are substantial and we are prepared to do more of that.

Mr. **Wortley**. I commend you for your efforts. You are on the right track. Has my time expired, Mr. Chairman?

Chairman **LaFalce**. Try another question.

Mr. **Wortley**. I was going to ask Mr. Naylor kind of a hypothetical. Suppose the system were to go to the market next week and find that they were unable to obtain any funds? What is this administration prepared to do at this time to assist the Farm Credit System and to assist the farmers in this country who need that credit?

Mr. **Naylor**. First of all, that would be a highly improbable occurrence. But if you make this assumption, the System has a couple of options available to it. They can access the discount window through the Federal Reserve, and also access a limited amount of funds through the Secretary of the Treasury, both of which are options to allow them some flexibility and time to access their own considerable liquidity.

The system has been developing a substantial amount of liquidity and is in a position to do a great deal for itself in the event of such an occurrence, highly improbable as it might be.

Chairman **LaFalce**. Due to the ongoing vote, I am going to ask Mr. Carper to assume the chair and to question, and I will try to be back within about 8 minutes.

Mr. **Wortley**. What about the Farmers Home Administration, is it prepared to step in and make any greater efforts?

Mr. **Naylor**. The Farmers Home Administration will have a substantial expansion of its activities in the coming year, both in terms of direct lending and in terms of guaranteed authorities which can be drawn on by the cooperative Farm Credit System and commercial banks.

We expect that that substantial additional authority will be fully used during the coming year.

Mr. **Wortley**. That is, I think, the end of my time. Thank you very much, Mr. Naylor.

Mr. **Carper** [presiding]. Mr. McMillan.

Mr. **McMillan**. I have a few quick questions here. Tell me what some of the legal restraints are on pooling the surplus and reserves of the various farm credit banks and related institutions to achieve the objectives that we are talking about, that is, consolidation.

Mr. **Sims**. Well, the Farm Credit System, I think, has been accurately portrayed as a loosely federated group of cooperative organizations joined together to get its funding centrally through the funding corporation in New York.

The 37 banks are jointly and severally liable for those bonds, and therefore, we have set up agreements amongst ourselves that would trigger capital movement among the banks in the event that capital of one of the banks was impaired.

Those agreements do not include the local associations, some 800 Federal land bank associations and production credit associations, the PCA's are dependent on the Federal intermediate credit banks for funds.

As we pull those funds together, for example, in the Omaha bank, it has an economic impact on the giving banks as they write checks to Omaha or Spokane, and certainly there is resistance at the local level of taking their capital that they have worked hard for 50 years to accumulate and affect their lending operations.

So, one of the proposals here would be the ability to assess that statutorily, but also our concern is assessing that in such a way that they continue to be viable lending operations that will carry out the mandate of Congress.

Mr. **Naylor**. May I add a comment to that from the administration's perspective? One of the problems the System faces is that while they have developed loss sharing agreements, they are exceedingly complex and lengthy processes. In many cases, the funds under the agreements are not available until they are in extreme difficulty.

The ability to marshal the surpluses and use them in a timely and positive fashion becomes a critical issue. Had that capacity been there on a systemwide basis earlier, many of the local problems in two of the System's districts might have been substantially mitigated or even, in some cases, prevented.

Mr. **McMillan**. Can that be remedied by legislation?

Mr. **Naylor**. It is our view that appropriate legislation, properly structured to be able to grant that authority, does two things: it provides for the effective pooling and utilization of surpluses and better management of problem loans; and also provides for continued autonomy of the local association unit and protects its ability to function, which is a desirable goal of many members within the System.

Mr. **McMillan**. Do those stock owners, I think, you referred to them, do they have any unusual rights with respect to the assets that they own? These are members typically of the bank, who are farmers or agribusiness interests or perhaps others?

Mr. **Sethness**. This is stock unlike most other stock.

Mr. **McMillan**. I gathered it was.

Mr. **Sethness**. It is not like a corporate equity issuance. In essence, one of the requirements of getting a loan from the co-op is to become a member of the co-op, and the membership fee is 5 percent of what you want to borrow.

That is your borrower stock, which you in the land banks anyway are entitled to get back when you repay your loan.

Mr. **McMillan**. But the source of that comes from the loan itself, and not from the borrower?

Mr. **Sethness**. That is correct.

Mr. **McMillan**. So it is an automatic 5-percent reserve that is set up at the beginning, so it is really a reserve rather than stock equity in the traditional sense of the word.

Mr. **Sethness**. I am not sure exactly what it is.

Mr. **Sims**. It really reflects the farmer's ownership in his cooperative lending institution.

Mr. **McMillan**. But the funds are provided by the lender not by the farmer?

Mr. **Sims**. In some cases, but not all.

Mr. **McMillan**. I was getting at the question of any legal constraints on the use of that stock as a basis for being readily available to the entire system.

Mr. **Naylor**. Those stock holdings are at-risk funds, but the funds we have been primarily addressing here are surplus accounts over and above that. We believe that if the funds and surpluses in loss reserves are effectively used, it will not be necessary to impinge upon the stock holdings of individual borrower members. Using projections, I think we generally agree the System would never fully exhaust the surplus funds available before seeing a turnaround in operations.

Mr. **McMillan**. I can see that, but a person, an institution buying bonds or notes of the entity would view that stock as basically a security against their notes or their bonds?

Mr. **Naylor**. That is correct. That is at-risk capital.

Mr. **McMillan**. With the request for the $6 billion from the Treasury, is it anticipated that if that were done in whole or in part that that credit would be subordinated to the outside creditors or would it simply be in addition to? How would it rank with respect to other creditors of the Farm Credit System?

Mr. **Sims**. It would be after the bond holders, but before the stockholders and that is the way it has traditionally been handled, when the System has had Government funds before.

Mr. **McMillan**. Thank you, Mr. Chairman. I have no further questions.

Mr. **Carper**. Gentlemen, I don't think I am going to have time to get into questions. I would like to have asked Mr. Naylor to restate the administration proposal and for each of our witnesses to critique it, and you may have already done that.

Mr. Sethness, would you critique it, maybe in about a minute, and I think I will have to run.

Mr. **Sethness**. We are jointly on the proposal.

Mr. **Carper**. Sometimes administrations speak out of both sides of their mouths. Mr. Sims.

Mr. **Sims**. I think our view is that we have tried to get out in front of our problem financially, recognizing that our bond market problem is here today, and Mr. Shumway referenced the patient.

We have found an illness, and that is this development of the nonaccrual loans that are building. I concur with Mr. Naylor that the time to deal with problems is on the front end of those problems, because they are the least costly on the front end, and we might have some criticism for the amount of time we took to get to the Spokane problem.

But I think what we are trying to do here is deal with this problem on the front end to minimize the cost both to the public as well as to the farmer stockholders of the System, and regain the confidence of both the investor and the farmer through the use of this loan.

Our view is that we cannot do that without a strong signal from the Government that it has put in place a mechanism not only to stand behind our securities, but to deal with the growing asset problem that we are experiencing in the System.

Mr. **Carper**. I am going to recess the committee for just a moment. I expect the real chairman to return posthaste and I am sure he will resume. Thank you for your indulgence.

[Recess.]

Chairman LAFALCE. The Subcommittee on Economic Stabilization will reconvene.

Since no other member of the subcommittee is present we will now call upon Mr. Leach for his questions.

Mr. LEACH. Thank you, Mr. Chairman.

What I am a little up in the air about is the certainty with which figures have been presented. It seems that every 3 months we get about a 30-percent greater pessimism on Farm Credit System statistics.

The administration has taken the position to date that it doesn't want to take a very long-term approach to the Farm Credit System until it understands it better and until better statistics are in. Yet at this time you are asserting before this committee what appears to be a pretty definitive look at farm statistics, including the observation that everything will get better in 1988, which is a rather distorted assessment.

In addition, the testimony doesn't totally jive with the statistics. On the one hand the assumption is made that all the System needs is a structural reform and perhaps a Federal loan; but on the other, Treasury acknowledges—I quote Mr. Sethness' statement—"the system has asked for very large cash infusions of taxpayer funds."

If the system is not in difficulty, presumably it wouldn't ask for that money. If it is in difficulty presumably it needs it or it needs another approach.

My sense is the only way you shore up a system if it is in difficulty, and I am pessimistic, and everything I read about assessments of the agricultural economy is substantially more pessimistic than what is presented here today in terms of statistics, the only way to shore up the Farm Credit System is to make a capital infusion or to decrease the system's liabilities, which means some sort of bondholder accountability.

My own assessment is that the problem has exploded in Washington at the wrong time and that we are unlikely to come up with a lot of new money, either the administration is unlikely to support it or Congress is unlikely to go along, and therefore, we might have to look at the bondholder accountability issue. There are those that object to it in that it suggests that there are a lot of difficulties with it, but when you really think it through, it is Wall Street that is being asked to be protected. I don't think Wall Street ought to be given a blank check, and I don't believe in Wall Street welfare.

On the other hand, I understand that the Treasury, has requested that we not ask about bondholder accountability techniques so I won't do that, but I would suggest that if you think it through, the proposal that has been so far presented by the system is window dressing because all you have asked for is a loan, and a loan is something that can come through the Federal Reserve discount window and it is something that can be gotten through simply more borrowing on Wall Street. So the fact is you are not asking for very much and that presumably that means at some point if the system is in more difficulty there will be more asked for. I hope everyone in Government keeps their options open because it looks like things will be far worse rather than far better in the farm belt in the next couple of years.

It raises an aspect everybody has to keep in mind and that is the issue of farmer stock. I want to raise it because many outside of the Agriculture Department have not really thought through the farmer stock issue in the sense of what is farmer stock.

It is my argument that it has always been a misnomer, that farmer stock in essence is a deposit upon which no interest is gained but on which interest is paid, and that it ought to be protected in the same way a bank deposit is protected. I am far more interested in protecting farmers stock than in protecting Wall Street.

In effect, we have a holding pattern and an administration requested delay, and I hope that that delay is not based upon a desire to, in effect, exhaust the resources of the System, which becomes code for exhausting farmer stock. I will personally hope that we would look for bondholder accountability far before we look at alleged farmer stock accountability because that will be another whopping loss for the farmer, and I think these losses ought to be shared.

So, I particularly wanted to ask the representative of the Treasury Department, is this administration committed to preserving the so-called farmer stock in the Farm Credit System?

Mr. **Sethness.** I am not sure that I can answer that question. I know that the analysis that we have done to date leads us to believe that that is unlikely to become an issue.

I would like to comment quickly on one thing you said earlier, which is that the farm economy is going to improve in 1988 according to these figures. That is not true. It need only get no worse than the declines already projected through 1986 and 1987.

Mr. **Leach.** No worse—worse is a downward trend, and if that trend is maintained it is going to be very negative. We have already lost an average of about half the asset values of rural America. In many areas of Iowa we have lost 60 percent of the asset values, and I guarantee you those are not reflected in the statistics that you have presented before the committee today. What you are doing is making to some degree educated good faith gestures, but to hang an administration policy on statistics that the administration admits are inadequate, I think, is dubious public policy, and that is one reason why it is so distortedly important to get a good handle on statistics.

In that regard, you have got institutional difficulties. The PCA's have a little firmer grip on timely necessity of statistics because they make shorter term loans although their loans may not be too viable.

All you know about in the land lending part of the Farm Credit System is whether or not a payment is particularly current.

And here it looks like a bedeviling problem coming in the very near future. Beyond that, we have two things that are going to have to also guide your judgments on whether things are going to hold stable.

One, is Gramm-Rudman which gives the Secretary of Agriculture, at least in current drafts, the authority to revise downward target loan pricing to meet any order of sequestering.

That implies some real question whether even current levels can be maintained and it implies a very real difficulty to come.

In addition, Gramm-Rudman implies almost certainly less resources for the Farmers Home Administration. We all know that a lot of the problems of the PCA's particularly have been picked up by Mr. Naylor's jurisdiction, the Farmers Home.

If we are going to have less money for Farmers Home, it only implies one thing, more difficulty in the farm belt. Every trend is downward.

Therefore, the basis of making a statistical analysis that is optimistic raises one's eyebrow.

All I can say is that maybe someone ought to ask what statistics did the Farm Credit System use when it went to the Treasury to ask for substantial taxpayer infusions of money. Maybe they are more valid than the statistics being presented today.

Were different statistics and statistical analyses used when they came before you than are being used today?

Mr. **Sethness**. No. We, in fact, based our conclusions essentially on numbers developed by the Farm Credit System, and FCA. We investigated—and all of these numbers were based essentially on work done by the U.S. Department of Agriculture's research service.

Mr. **Naylor**. Could I clarify some observations here?

Mr. **Leach**. Of course.

Mr. **Naylor**. The Farm Credit System is in the process of making a very fundamental change in the way it evaluates problem loans. The assessment which they have now completed with the Production Credit Association, and in the land banks based on a projection of land values, and the collateralization of those loans, is taken into account in their current projections.

The numbers that we are both using are essentially the Department's economic services projections. They anticipate continued decline in farm income over the next 2 years, and continued declines in land value. We factored this data in on the basis of what reasonably should be expected within your area and on a national scale. We developed projections on the anticipated volume of problem loans for the Farm Credit System over the next 2 to 3 years, and how much will be needed to fully reserve for projected losses of those loans.

We are looking at potential problem loans, for example, in the case of the Farm Credit System, of some $13 billion. Not all loans in those projections are delinquent at this time.

Indeed, many currently paid loans are carried now or will be soon carried by the System as troubled loans for which they have reserved because of collateral or some other related loan problem.

We are very conscious, as you are, that when it comes to a financial institution we must be exceedingly careful to make judgments using the most reasonable and conservative figures possible.

Anything less would be very misleading and not in the interest of the farmer or the financial institution involved. We made every attempt to avoid that.

Mr. **Leach**. I appreciate that.

I just would like a little bit of extra modesty that these statistics and figures that you presented are the best judgments at a precise point in time and that based on the last three or four series of statistics presented they have been underestimated.

I will end with one question, and I would like to ask more, but I think it would be fairer if you did a second round, Mr. Chairman.

Chairman **LaFalce**. There will be a second round.

Mr. **Leach**. I think we should understand that the administration is being asked to give another loan, therefore, there will be no extra pressure taken off foreclosures and no extra asset appreciation or liability reduction in the current proposals before the Congress coming from the Farm Credit System and so some of the rhetoric that will be stabilized land values, it is rhetoric, not substance.

We hope that that occurs over time, but that will be left to something in the marketplace rather than a proposal on the table before the Congress at least backed by the Farm Credit System. You asked for the Government to come in and make a loan, that is to open up the Treasury.

Will the Treasury loan be secured above that of the bondholder, and if it is secured above that of the bondholder, does that mean that bondholder liability actually becomes greater if the System gets in more difficulty?

Mr. **Naylor**. I believe I will let Doug answer that.

Mr. **Sims**. Our proposal calls for capital notes to the Government which would be below the bondholder.

Mr. **Leach**. So, the bondholder will be protected more than the taxpayer in the event of difficulty, so that if one assumes that liabilities in the System exceed assets, they become Government grants?

Mr. **Sims**. I would refer you back to the System's track record on that.

What the System is saying is that those loans from the Government would be repaid out of future earnings of the System after we get through this transition.

Mr. **Leach**. We all hope that is the case but we have to recognize that the System's track record is a lot of loans have been made in the last 5 to 7 years as a percentage of the System's total loans and that was at a time of higher inflation and higher asset values than exist today. So the fact that the System has a 50 year good record, is no basis for assuming that the next few years will be quite as excellent.

I have other questions.

I would like to defer.

Chairman **LaFalce**. Mr. Bereuter.

Mr. **Bereuter**. Thank you for your testimony.

I might say it would have been a lot more helpful if we had had this a day in advance so we could have gone over it because it is so voluminous. I think one of the points that needs to be made is that the Farm Credit System is not a system in the way that someone has responsibility for making decisions and implementing them. I think it is a confederation and that is one of the problems.

I also hear a lot of discussion about how things are going to be bottoming out or improving in 1987 or 1988, and I get a little tired of hearing that because I don't think there is anyting happening or proposed in this Government, or anywhere in the world that suggests that we are going to have an improvement in 1988. All the actions you are suggesting and the proposals you are making seem to be based around that assumption.

Not just you gentlemen but others. I don't see any reason for those kind of assumptions.

I want to quote you, Mr. Sims, directly from Mr. Naylor's presentation and see if you agree or disagree.

Restructuring the Farm Credit Administration into a true arm's length financial regulator whose authority would include matters of entry and exit capital safety and soundness and enforcement of supervisory directives—speaking for the council, do they accept the merit of that proposal for the administration?

Mr. SIMS. Yes; we do.

Mr. BEREUTER. Restructuring the present management board with a single chairman appointed by the President confirmed by the Senate.

Mr. SIMS. Our proposal as we presented it to the House Agriculture Subcommittee proposed that it would be a three-member board appointed by the President and confirmed by the Senate with a chairman.

Mr. BEREUTER. Do you believe that there is a necessity for a centralized reserve or capacity of that board to be able to move reserves within the System on their own decisions?

Mr. SIMS. Yes; I do. I believe that is consistent with the warehousing concept of the Farm Credit System Capital Corporation and the System self-help program.

Mr. BEREUTER. And that will take a statutory change; isn't that correct?

Mr. SIMS. That is correct.

Mr. BEREUTER. With respect to the Farm Credit System's Capital Corporation and any proposed financial warehouse for bad loans, I haven't heard any discussion of taxes? Will the warehouse entity pay delinquent taxes, will they pay—will they make in lieu of tax, payments for property tax and for income tax?

Mr. SIMS. That particular detail has not been addressed Mr. Congressman, to the extent that they owned the property that will be dealt with as it presently is in the Farm Credit System.

Mr. BEREUTER. I am not sure I understand that.

You don't know the answer to that at this point?

Mr. SIMS. I do not. We have not dealt with that level of detail.

Mr. BEREUTER. Since the problems of the country are so heavily centralized in the grain belt that is of particular interest to this Congressman. So I want to know if you assume ownership in that warehouse that you are going to pay delinquent taxes and make in lieu of tax payments exactly equal to the property and income tax that would have been paid?

We have taxes in political subdivisions, particularly in school districts that are very difficult for us to operate. I think that is a crucial answer I have to have.

Mr. SIMS. OK.

Mr. BEREUTER. I believe it was you, Mr.—I am not sure—perhaps two of you, but I think you, Mr. Sims. Perhaps Mr. Sethness suggested that the warehouse concept could be modified or adapted or other institutions. That would take a statutory change.

You created the warehouse under existing authority, but is the assumption then that such institutions would include commercial agricultural banks and the Farmers Home Administration, bad loans from those two sources, as well into a warehouse for bad loans, a financial warehouse?

Mr. SIMS. We have not proposed that in our particular legislation, no.

Mr. BEREUTER. I can understand why you wouldn't answer I don't mean that derogatorially. I wanted to know if that is what you are talking about, whoever made that suggestion, because it is my assumption that we are not out to help the Farm Credit System in the abstract, we are interested in the borrowers that that institution, even in a confederation form, serves.

I have a hard time justifying why we are helping one institution to help a borrower when we are not willing to help the institution serving his neighbor. And I think it has political liability—if it has political liability to the Farm Credit System I think it has political liability to the other major agricultural lenders.

That is a statement but I wondered—I would like to hear from the administration on that, as a matter of fact.

Mr. NAYLOR. We have not specifically made a proposal of that nature, and, frankly, it is our view that it is not proper or needed for several reasons. First of all, commercial banks are primarily short-term lenders, and we have established a very substantial, guaranteed loan program through the Farmers Home Administration. This program gives basic support to their system, including some proposals involving interest rate offsets under consideration by Congress at this time.

That gives a good deal of strength to the commercial banks. The real estate situation is somewhat different and is primarily a Farm Credit System problem.

Farm real estate lending within this country essentially is focused on the Farm Credit System. The second largest group in that category are contracts for sale, and insurance companies have the third largest group along with Farmers Home Administration.

These groups don't require the kind of assistance needed by the System because they are not experiencing the problems as the Farm Credit System.

Mr. BEREUTER. My last question at least for this round, Secretary Naylor, are you aware of the fact that the Farm Credit System is in part solving its problems by forcing borrowers out of the System and that they, in turn, are expecting to turn and are turning next to the Farmers Home Administration, as well as commercial bankers?

Mr. NAYLOR. We are aware of that. Our three principal objectives in evaluating any solution have been, one, that we are able to maintain a competitive source of credit through the Farm Credit System to borrowers, farmers and ranchers throughout the country.

Second, that a reasonable policy of loan management, restructuring and other steps is sustained and that we minimize the risk to borrower stock. It is our view that through the proper pooling and utilization of surpluses a very responsible loan management program can be sustained by the System. By and large, they are not in your area taking these steps. Loan reassessment on a prudent basis, restructuring and loan workout options that are typically used by workout officials are not currently being effectively used within the System——

Mr. **Bereuter**. Within the Farm Credit System?

Mr. **Naylor**. Within the Farm Credit System. The proper pooling of their resources and use of their capital corporation would provide them with the ability, and the responsibility for engaging in sound loan workout efforts with their borrowers.

Mr. **Bereuter**. Wouldn't it be good public policy to let people know the huge backlog of requests we have from approved loans from the Farmers Home Administration?

We have created expectations that their loans are going to be approved, and even though they are eligible to be approved, the backlog is just incredible.

Mr. **Naylor**. I am not aware that we have a backlog on operating loans with the agency. We have cleared out our backlog from the last lending season.

Mr. **Bereuter**. That is not the case in my State according to the State director.

Mr. **Naylor**. The last information I have is that we are essentially current on our operating loan applications for the last year. We had no restrictions on funding availability with regard to those funds during the last year and made every effort to complete processing on the outstanding applications.

Mr. **Bereuter**. Thank you, Mr. Chairman.

Chairman **LaFalce**. Thank you Mr. Bereuter.

Mr. Sims, do you agree with Mr. Sethness' observation the Farm Credit System will run into the black by 1988?

Mr. **Sims**. We have not developed projections for 1988. Our projections only go out through the end of 1987.

Our conclusion is that we do not know how it could return to profitability carrying that heavy a level of nonaccrual loans, and so it is doubtful from our point that we would return to profitability in 1988.

Chairman **LaFalce**. Mr. Sims, you are asking for a line of credit for some $6 billion. What would you use it for, and is it really $6 billion that you need as a line of credit?

Mr. **Sims**. We believe over the period of the next 3 or 4 years we will need a maximum of $6 billion. The money would be utilized to cover the cost of carrying the nonaccrual loans that are building on the balance sheet that we think will peak at between $9 billion and $11 billion.

So, it would, in effect, subsidize the interest that we would pay on the debt that we issued to carry those loans and then would be repaid out of the future earnings of the Farm Credit System.

Chairman **LaFalce**. Does that money that you won't make recourse to your earned surplus?

Mr. **Sims**. We would. We would be utilizing the earned surplus. As we were utilizing that and would not show the terrific losses that are projected that would both give confidence to the investor and to the farmer and would allow us the time to restructure those loans on the books of the banks.

Mr. **Naylor**. Mr. Chairman, if I might, I think perhaps that reflects the fundamental difference here.

It is our view that if the System comes forward with a forthright plan of the effective use of its resources, and a plan for the use of those surplus funds to deal with their problem loans, that this will not jeopardize their access to the market as long as that plan is forthright and clearcut and projects what the long-term situation will be. It is not necessary to, in effect, not show a loss in order to maintain market confidence.

And that, in part, is what the System is proposing to do, as Mr. Sethness indicated, to book operating losses that shouldn't be there, and would indeed be expected under the conditions they are faced with.

Chairman **LaFalce**. Wouldn't the approach suggested by Mr. Naylor, rather than by Mr. Sethness, be an honest approach to show the losses?

Mr. **Sims**. The losses will be shown on the individual books of the banks as they both write off the loans, and as they write the checks to the Capital Corporation for self-help.

Where the money comes in is into the Capital Corporation, which, on a consolidated basis, would in effect be carrying the debt that we moved over to that Capital Corporation.

Mr. **Sethness**. Is the proposal one that you take a borrowing in as income?

Mr. **Sims**. Either utilized as income or stock, whichever was most appropriate, in terms of either carrying nonaccrual loans or providing financial assistance to banks.

Chairman **LaFalce**. As income or stock, would that be accepted by Price Waterhouse?

Mr. **Sims**. Yes, we believe it would.

Chairman **LaFalce**. Would that be accepted by Treasury?

Mr. **Naylor**. I think we would have some problems with it.

Mr. **Sethness**. I am not an accountant. I am having a little trouble understanding the transaction, but it may, in fact, work out.

Chairman **LaFalce**. I am glad you said that, because I was having some trouble, too, and I thought maybe it was all my fault.

I want to go into this Capital Corporation a bit that all three of you talked about now.

Mr. Sims is talking about it with an infusion of $6 billion from the Federal Government. Mr. Naylor and Mr. Sethness talked about it with no infusion of capital from the Federal Government.

Let me ask you this legal question: Under existing statutory law, is there any financial assistance that the Federal Government can provide to the Farm Credit System, and agriculture banks, for that matter, through the Treasury, through the Federal Reserve, Farmers Home Administration, or any other governmental agency?

Mr. **Sethness**. Let me hasten to point out——

Chairman **LaFalce**. All of a sudden we discovered the Federal Financing Bank in order to deal with the debt ceiling problem, and then when the Federal Financing Bank was going to exhaust its borrowing capacity—and the Federal Financing Bank is really the Treasury Department—all of a sudden we discovered accelerated redemption, and we discovered accelerated redemption for about a

2-week period. Some individuals say we could discover it for about an 18-month period.

What discoveries might we be able to make under existing law, assuming we wanted to give financial assistance?

Mr. **Sethness**. I am not aware of any great discoveries. Treasury doesn't have money of its own. It has money or authorities to borrow money granted by the Congress.

There is a very limited authority for the Farm Credit System to get, I think it is $266 million, from the Treasury, which represents funds that were originally repaid by the System from its original capitalization by the Government.

There is a limited ability for the System to access the discount window at the Federal Reserve, and there are——

Chairman **LaFalce**. You say limited ability to access the discount window. Could you spell out the parameters of that?

Mr. **Sethness**. The borrowings are limited by the ability to pledge collateral acceptable to the Fed.

Chairman **LaFalce**. It wouldn't have a lot of collateral within the farm system, then?

Mr. **Sethness**. The collateral is already being used for its borrowings from the market, so you have to find collateral from the bottom right-hand side of the balance sheet and the assets represented by that.

Chairman **LaFalce**. How much of its collateral has already been used to go to the bond market?

Mr. **Naylor**. Fully pledged securities, about $70 billion.

Chairman **LaFalce**. How much is left over?

Mr. **Naylor**. I believe——

Mr. **Sims**. I believe September 30 it was roughly $8 billion.

Chairman **LaFalce**. Did you have some other point you wanted to raise, Mr. Naylor?

Mr. **Naylor**. No, there is limited authority, basically without special action by the Chairman of the Federal Reserve, for the FICB's to borrow at the discount window, and the law does require that the Federal Reserve Board declare an extraordinary emergency to open that window to all components of the Farm Credit System.

Chairman **LaFalce**. So if we are talking about borrowing and that is what we are talking about when we refer to a line of credit from Treasury, would there be any fundamental difference in borrowing from the Treasury and in borrowing from the Federal Reserve Board for which you presently have statutory authority?

Mr. **Sethness**. I am not sure who the "we" was meant to be, but I think——

Chairman **LaFalce**. The Farm Credit Council.

Mr. **Sethness**. The Federal Reserve is not basically in the business of making long-term loans through the discount window. At least they try not to.

Mr. **Sims**. Our understanding of that is that we only have limited authority through the discount window for the FICB, as Mr. Naylor described, and then to the other banks only as a lender of last resort.

Chairman **LaFalce**. Mr. Naylor also said you would have limited authority right now through the FICB's, but this would be able to be extended if the Federal Reserve Board declares an emergency situation.

Mr. **NAYLOR**. Yes, that is correct, and that is subject to the terms and conditions of the Governor of the Federal Reserve.

That would also be subject to the terms and conditions established by the Chairman of the Federal Reserve for supplying those funds. In other words, the loan agreements that would have to be entered into between the System and the governor.

Mr. **LEACH**. Would the gentleman yield on that point?

Continental Illinois got enormous security for the loans that were made and took a first position. Are you telling this committee that it cannot take a first position over bondholders if it were open to the discount window?

Mr. **NAYLOR**. Congressman, that is a highly technical point and I am not sure I can correctly answer it without referring to counsel.

Mr. **LEACH**. It is very important. If we are looking at the possibility of the need for emergency funds and the Fed cannot take a priority position, the Fed might well be precluded from acting. It could well be, in whatever legislation comes before this Congress, that we would want a provision in that legislation that would give the Fed a priority position in the event that the discount window was open.

So I am truly surprised that the burden of this testimony seems to be that the Fed cannot come in ahead of bondholders, because if it can't, a prudent Fed under pretty firm legal stricture might be precluded from acting, and so that question is of profound significance.

Mr. **SETHNESS**. The Fed will come in only when it is adequately secured in accordance with its own view of what represents adequate security, so as to the assets that they take as security, they will be the prior claimant ahead of the bondholder.

Mr. **LEACH**. They have the right today to come in ahead of the bondholder.

Mr. **SETHNESS**. If collateral can be identified and segregated, that is satisfactory.

Chairman **LAFALCE**. Even that collateral that has already been put up?

Mr. **SETHNESS**. I don't believe you can go after the other collateral.

Mr. **LEACH**. Excuse me.

Mr. **NAYLOR**. We were trying to get at this, this is a highly technical point.

I am not sure that the Federal Reserve, can take a priority position over existing bondholders, collateral that is already pledged to that.

Mr. **LEACH**. Can we request this, because there is confusion on this issue, that we have a written response, from either Treasury or Agriculture on what position the Fed can take, and second, with that a recommendation on whether in any legislation affecting the Farm Credit System, that that issue ought to be addressed. This is a truly crucial issue because one of the aspects is, there is some chance Congress will do nothing this fall, and you have got a 2- or 3-month hiatus in which there may be emergency action needed and second, whether or not Congress does act, if it does, perhaps we are going to have to address that issue and that, in and of itself, may be a driving force for legislation.

Chairman **LaFalce**. We have been trying to work with the Federal Reserve on that question.

Mr. **Leach**. I apologize for interrupting.

Chairman **LaFalce**. No—excellent point.

Mr. **Sims**. It is our understanding of the System that we cannot pledge collateral already pledged to the bondholders, and we do not view the line from the Fed to be a solution to our problem.

Chairman **LaFalce**. In the Chrysler loan guarantee situation, I am trying to think if we didn't give the assistance——

Mr. **Leach**. If you will yield on that? I will mention one point on the Chrysler loan guarantee. The background on the Banking Committee was that the loan guarantee came out of the Banking Committee without giving the Treasury prior position. But an amendment that the gentleman from Iowa offered and which became part of the bill that came out of the Congress as a whole, the Government was given a priority position to all bondholders. I would suspect that that sort of concern would be reflected in the House as a whole and on any effort that was made on any Treasury line. I apologize for intervening on the gentleman's time but I do think it very important that the Treasury indicate if it likes the position of the Farm Credit Administration that you come after the bondholder in the event of a loan, or does it want a priority position?

Mr. **Sethness**. Congressman, our position is that we don't want to have a line available, so I am not sure I want to try to negotiate the terms of the line.

Mr. **Leach**. Do you want a priority position or a secondary position?

Mr. **Sethness**. Sure.

Chairman **LaFalce**. Of course they would want a priority position, but the question whether Treasury would get a priority position would need above and beyond the $240 billion or so, legislative action, the ability of the Federal Reserve to give a loan exists under present law, and inquiry whether, prior to the Fed acting, and even in order to give greater ability to the Fed to act, it might be necessary to give them specific authority to take a prior position, or condition their ability to act on the bondholder's acquiescence in a prior position. That is what we did in the Chrysler loan guarantee.

I don't think we legislated prior position. I think we legislated, as I recall, Jim, that prior to giving any assistance, there would be an agreement that they could have a prior position. It was the creditors who saw that it was in their best interest to allow the Government to take a prior position, and this would be a situation where the bondholders, in order to get the participation of the Fed, or the Treasury, would have to go along.

Is my recollection correct?

Mr. **Leach**. Well, partly.

Chrysler announced in the strongest possible terms that there was no chance that the so-called Federal loan guarantees would work if the Government got a prior position.

However, the amendment that came before the House floor which was adopted and ended up working did give the Government a prior position and, in the event of any default, the Government came ahead of all bondholders, all debtors to the Chrysler Corp.

Chairman LaFalce. Or did we just say prior to the Government giving a loan, there would have to be an agreement, to take a secondary position?

Mr. Leach. We did it by legislation which required that the creditors take a second position, but it was legislatively mandated.

Chairman LaFalce. I will have to check that, OK.

Let me just ask all of you now, how this Farm Credit Capital Corporation would work. First, Mr. Naylor and Mr. Sethness, how would it work in the absence of Federal financial assistance? That is what you are advocating.

Mr. Naylor. It would work essentially the same in either case.

Chairman LaFalce. Second, have you spelled this out in legislative specifics for at least the Agriculture Committee? Is there a bill that the Agriculture Department and Treasury Department have drafted that spells out exactly how this Farm Credit Capital Corporation would work?

Mr. Naylor. We are currently developing such a document. A similar document has been developed by the Farm Credit Administration which they delivered to the Agriculture Committee and it is also incorporated in the Farm Credit Council's bill. We have also provided, I think to your committee, Mr. Chairman, but would be happy to do so if we have not, a general outline of our checklist, if you will, of the key points that we feel are appropriate to be incorporated.

Chairman LaFalce. We would like copies of all proposed legislative vehicles from whatever source, with or without financial assistance, but spell it out without financial assistance.

Mr. Naylor. Essentially, what the System is doing is either through the issuance of stock or such other securities as may be appropriate, pooling the surplus funds from those entities within the System which have them available, bringing them into a central pool, and then allocating them to deal with problem loans efficiently, or to strengthen individual units that are in financial jeopardy.

In effect, it is a clearinghouse and a central control point for the effective marshaling and application of resources.

By and large, it anticipates that individual loan restructuring and loan work would continue to be carried out by the local lending officials that have been dealing with the individual customer.

Chairman LaFalce. So it is not a warehousing situation then, is it?

Mr. Naylor. You would transfer to the corporation a problem loan at its current face value, as part of that process, and it would be held by the capital corporation on its books until it is dealt with either through restructuring, put back in a performing status, or it is in some form liquidated.

Chairman LaFalce. Would you care to add to that, Mr. Sethness?

Mr. Sethness. I think that the transfers would take place not at current face value but at market value.

Mr. Naylor. That is correct, at market value.

Chairman **LaFalce**. All right, counsel advises me that some of the witnesses have time constraints that will necessitate their leaving almost immediately. I will forego the rest of my questions, although I will ask each of you to address in writing the set of questions that I posed to you, to the extent that they have not been answered adequately during today's hearing.

Mr. Sethness, both you and Mr. Sims did mention the effects of its possible difficulties from Farm Credit System bonds, for other agency bonds.

How close of a link do you think there is going to be? Isn't there a clear difference in the financial difficulties of the Farm Credit System system's bonds and the bonds of other federally sponsored but private entities?

Mr. **Sethness**. There are clear differences in the balance sheets and income statements of each of the "agencies." We keep putting that in quotes.

However, I think that in the eyes of the investors who tend to buy them, and in the eyes of the dealers and traders on whose desks they are all dealt with, there are great similarities.

There are also a long list of indicia of agency status that each of these securities has, including exemption from the 1933 act, and including tax provisions, eligibility as collateral for Treasury tax and loan accounts, a whole series of things like that and all of these agency securities have those indicia in common, and I think that says that there would be a very sharp ripple effect from the default, default on the part of any one of the agency borrowers, to the capability of the others to get access to the market and reasonable cost.

Chairman **LaFalce**. We have many other questions. We just don't have the time to ask them.

I will ask you to respond to our questions in writing, and gentlemen, thank you very, very much for an excellent hearing.

The subcommittee will stand in recess until 9:30 tomorrow in room 2128 of the Rayburn Building.

[Whereupon, at 4:35 p.m., the subcommittee was adjourned, to reconvene at 9:30 a.m., on Thursday, November 14, 1985, in room 2128.]

[The following material was submitted for inclusion in the record:]

RESPONSES BY FRANK NAYLOR TO QUESTIONS SUBMITTED BY HON. JOHN J. LaFALCE

QUESTION 1: Do farmers still require the Farm Credit System (FCS) and all its parts? Can they find alternative sources of long- and short-term credit such that the government need not worry about protecting the FCS?

ANSWER: The FCS currently holds over 30 percent of all farm debt. It holds about 43 percent of all farm real estate debt (long-term credit) and 18 percent of total farm non-real estate debt (short and intermediate-term credit). PCA's hold some $18 billion in short and intermediate-term farm debt. While there are some regional differences in the market shares between PCA's and commercial banks, banks overall would find it difficult to replace the PCA's entirely as non-real estate lenders.

Both PCA's and commercial banks are now in a paydown situation with farm loans; however, the PCA loan portfolio is contracting at a considerably faster rate than that of the banks. This is partly due to the differences in interest rate pricing policies resulting from the FCS's use of average cost of funds loan pricing versus the banks' use of marginal cost of funds pricing. Swings in market shares have occurred historically as market conditions changed, so this is not unprecedented.

QUESTION 2: Could the FCS overcome projected financial problems without legislation providing federal financial assistance? How much would giving the FCA powers comparable to the FDIC and mobilizing regional FCS funds for use nationally by themselves affect the staying-power of the FCS and its perception in the bond market? How much financial assistance can the federal government provide to the FCS and ag banks under current law through the Treasury, Federal Reserve, or any other agency?

ANSWER: Assuming the projections of the amount of debt at risk are correct, the FCS can probably absorb these losses _if_ it can mobilize all the potentially available assets within the system, _and_ the timing of the loan losses is such that system reserves are not exhausted in the next few quarters before earnings can be used to augment reserves.

While the FCS has significant amounts of earned net worth and liquid assets, these funds are held by individual banks and associations and are not readily transferable between institutions. Although there is a tendency to view the FCS as a single entity, it is probably more appropriate to view it as a coalition of 37 banks and several hundred land bank and production credit associations each having somewhat different objectives and differing resources and obligations. This limits the FCS's ability to act in a unified manner.

Current law provides that the different banks of the FCS may access a Treasury revolving fund for a total of approximately $266 million, and the FCS may access the Federal Reserve discount window

Commercial banks and the associations of the Farm Credit System may apply for FmHA guarantees for operating and farm ownership loans for qualified borrowers.

QUESTION 3: Does the government have an obligation to back the FCS as some of its bondholders may have assumed? How much financial assistance can and should the federal government provide to farm lenders under current law? Do the circumstances of the FCS warrant specific federal assistance not extended to ag banks, other creditors in stress, or other institutions dependent on the farm economy?

ANSWER: The FCS explicitly states in all of its bond issuings and related data that it is not a federal agency and that the United States Government has no obligation to guarantee its bonds. The available evidence on who holds FCS bonds suggests that there are very few unsophisticated investors holding these instruments. The vast bulk of FCS bonds is held by commercial banks who would generally be aware of these conditions.

It is sometimes argued that because the Congress, through the Farm Credit Act, influences the lending policies of the FCS (including limiting them to serving only agricultural borrowers and prohibiting them from diversifying their portfolios), that some obligation exists to help the FCS without extending similar assistance to commercial agricultural lenders who do not suffer under the same restrictions.

We do not believe that financial assistance is necessary at this time, and, furthermore, if the regulatory reforms and the statutory authorities for the Denver Capital Corporation are quickly enacted, the Administration doubts that direct financial assistance will be needed at all.

QUESTION 4: How much would the cost of credit to farmers differ if government gave financial assistance under current law, if it gave no assistance, or if it adopted different forms of financial assistance? If there is to be legislation, how much difference would it make if Congress completes action early next session rather than this session?

ANSWER: The cost of credit is significantly lower for farmers who qualify for limited resource Farmers Home Administration direct loans, but for borrowers from the Farm Credit System, there would not be any discernible difference in interest rates if the system accessed the revolving fund or the discount window--the only source of Federal funds available to them under current law.

If no assistance is given, but the regulatory body is reformed, the system utilizes its surpluses in an efficient way and manages its troubled loans with care, we anticipate no negative impact on interest rates because the bond market will find comfort in these actions. The strength of FCS securities in the bond market is the key to stable and reasonable interest rates.

The timing of legislation is important for the very reason that the bond market must continue in its belief that the Federal establishment does have an interest and some authority in the efficient, safe and secure management of the Farm Credit System. Postponing action until the next session will send just the opposite signal to the market.

QUESTION 5: Does the traditional 15 to 30 basis point spread between Treasuries and FCS bonds indicate that bondholders have been paid to bear some risk for holding FCS bonds? Should the FCS, as a large financial institution that depends almost entirely on agriculture, be treated differently from commercial banks whose largest farm lenders are much more diversified and whose most ag-dependent lenders tend to be much smaller? If current FCS bondholders were to be required to "take a hit," would that raise the cost of borrowing for federal agencies? If so, what would be the effects?

ANSWER: The 15-30 point spread is a somewhat inaccurate reflection of the relationship between FCS bonds and Treasury bonds. FCS bonds have had lower yields than comparable Treasury issues in the past. Prior to the last few months, FCS bonds have had yields in excess of the 30-40 point spread. The spread reflects demand and supply conditions in both the FCS bond market and the extent to which Treasury bonds are substitutes but not identical instruments. In addition, the relative availability of the two instruments will also affect the price spread between the two types of security. If the Treasury is issuing large volumes of new issues, they are likely to trade at a high yield in order to induce bond holders to increase the relative share of Treasury bills in their portfolio. Similarly, during the 1970's when agriculture was highly profitable, the risk associated with FCS securities was negligible since the security backing the obligations had a market value exceeding the debt.

With an increase in perceived risk in FCS securities, the spread has increased, resulting in a premium for purchasers of these securities. In the primary market, FCS and hence its borrowers must pay the premium. In the secondary bond market, those selling "old" FCS bonds are faced with a loss if they sell the security. However, the yield that these individuals receive if they continue to hold the securities has not changed from the yield they agreed to accept at the time they bought the securities. Thus, if bond purchasers hold the security to maturity, they receive no more or less than they agreed to accept at the time of purchase.

FCS differs significantly from other financial institutions in a number of ways. In the first place, it is a highly specialized lender with a limited set of lending alternatives. The legislation governing the system restricts the terms of lending and sources of funds available to the system. Secondly, the FCS is a cooperative; the owners of the system are its borrowers. This results in a different set of operating objectives than would be expected in a profit-oriented firm such as a commercial bank where the owners and borrowers are different groups. Thirdly, the FCS is an association, not a single entity. The 37 banks operate as individual entities within a rather loose coalition that imposes little direct control on their behavior.

In addition, the various associations operate as quasi-autonomous entities outside the direct control of the FCA, and as ultimate owners of the FCS, determine objectives of the 37 banks within the conditions laid down by legislation.

Since the FCS is the single largest lender to agriculture and has by far the greatest exposure in land loans, its continued well-being is important to the stability of the sector. Although the 37 banks are not tightly linked, their joint liability for the FCS bonds requires that default by any individual bank be covered by the others. As a result, the problems of a single bank are implicitly the problems of all the banks. This linkage effectively places the entire systems debt in a collective pool.

Several studies have recently suggested strong links between FCS cost of funds after losses are recognized and the cost of funds to other borrowers; however, the evidence of the market suggests a weaker link. Costs of FmHA bonds have not followed the spread between FCS and Treasuries. This suggests that the bond market is capable of assigning differential risk premiums to the issues of different agencies. Because the FCS is "perceived" as an agency borrower, a failure of the system to meet its obligations would have a negative impact on the basis point spread for real agency borrowers.

QUESTION 6: What are the trade-offs between providing assistance to farm lenders rather than taking measure to raise the income of farmers?

ANSWER: Assistance to lenders will do little to help financially stressed farmers. But targeted assistance to farmers could relieve pressure now being felt by lenders. Assistance to lenders will enable bank owners to protect their equity and possibly avoid failure. In most instances, the lender's decision to foreclose on those operators in financial difficulty and facing loan repayment problems will not be influenced by whether or not they receive assistance at this point in the farm crisis. Measures to support income in the farm sector through commodity programs cannot be structured to assist only those farm operators in financial stress and generally encourages higher production and consequently lower prices—outcomes contrary to the needs of those in trouble.

Ultimately, the level of resources used in the farm sector needs to reflect market conditions. A coordinated program of commodity price supports tied to market conditions, export promotion, a conservation reserve, and targeted assistance to farmers with a realistic chance of being viable, represents a more balanced approach than assistance to lenders alone.

QUESTION 7: How do the current supervisory/regulatory powers of the FCA differ from those of the FDIC, Comptroller, etc.? If the FCA had already had such powers, how much difference would that have made to recent FCS performance?

ANSWER: The bank regulatory agencies, such as the FDIC and the Comptroller, require fairly standardized accounting practices, require frequent standardized reporting with most data collected being public information, and specify operating guidelines and requirements for which they have certain enforcement tools available. The FCA has much weaker powers than do regulators of banks. In order to assist troubled FCS banks (e.g., Spokane), the FCA must arrange a consensus among its member institutions. FCS institutions use their own classification schemes for defining problem loans.

Even if FCA had had powers comparable to FDIC, it is not clear that the current situation could have been avoided; however, the extent of problem loans would have been known sooner. Many commercial banks also are experiencing financial problems resulting from farm lending, in spite of closer oversight. Even with more uniform reporting rules, some banks are eventually forced to write down large quantities of loans once an audit takes place. Furthermore, the FCS is limited by law to making mostly farm loans.

A stronger FCA would have facilitated closer monitoring of the FCS, and the use of consistent statistical measures would have helped evaluation of FCS financial status.

QUESTION 10: What is the relationship between the FCS and ag banks in terms of competition, complementarity, and bond holding? How would assistance to the FCS but not ag banks affect that relationship? How do the FCS and ag banks compare in their costs of obtaining money and lending it?

ANSWER: The competitive relationship between the banks and member associations of the FCS and agricultural banks depends on type of loans, the structure of the local lending market, State banking regulations, conditions in national financial markets and a number of other factors. Banks and production credit associations generally are very competitive in providing short term credit. The Federal Land Banks are the largest farm mortgage lenders because of their ability to offers terms that are more conducive to the borrower's needs than those that could be offered by agricultural banks.

Because of their ability to pool risks, financial strength and repayment record, and perceived agency status, the banks of the FCS have been able to obtain funds from the national financial market at a generally lower cost than the banks. Banks, however, also have available a low cost source of funds in the form of deposits, a source not available to the FCS. What effect this has on lending is influenced by the pricing policies of the lenders. Banks charge rates that closely reflect their current cost of funds, while FCS interest rates generally reflect their average cost of funds. Historically, the FCS has been able to offer lower rates to farmers when national interest rates are rising. Banks are much more competitive when national money market rates are falling.

The impact of assistance to FCS would not affect the degree of FCS-agricultural bank competition. It is highly unlikely that Federal assistance would be at all significant in the short run,and consequently the competitive balance between FCS and agricultural banks would not be influenced.

RESPONSES BY CHARLES O. SETHNESS TO QUESTIONS SUBMITTED BY HON. JOHN J. LaFALCE

QUESTION 2: Could the FCS overcome projected financial problems without legislation providing Federal financial assistance? How much would giving the FCA powers comparable to the FDIC and mobilizing regional FCS funds for use nationally by themselves affect the staying-power of the FCS and its perception in the bond market? How much financial assistance can the Federal Government provide to the FCS and ag banks under current law through Treasury, Federal Reserve or any other agency?

ANSWER: So long as FCS can borrow at reasonable interest rates, the large FCS earned surplus and loss reserves will assure that FCS can remain a viable lender -- even with estimated losses of $5.5 billion for the rest of 1985 through 1987. There has been considerable uncertainty in the financial markets with regard to the extent of FCS loan losses and its ability to deploy its considerable resources to cope with them. It is worth noting in this connection that whereas yields on FCS securities jumped to as much as one percentage point over Treasuries in September, when the FCS problem was first focussed on by the markets, they have narrowed somewhat as discussions of the extent of the FCS problem and of FCS restructuring legislation have proceeded.

The Administration believes the Congressional preference for helping ailing financial institutions help themselves is the appropriate approach to the FCS problem. Thus, the Administration has proposed two basic changes in FCS. First, it must have the capability to mobilize FCS' considerable resources, under appropriate supervision, so as to deal effectively with bad loans and to provide assurance that borrower-owned stock is cushioned by systemwide resources. Currently, funds that are held by individual banks and associations are not readily transferable between institutions, limiting FCS' ability to act in a unified manner.

Second, FCA must be reorganized and reformed so that it will operate as an independent regulator of FCS. While it is debatable that greater regulatory oversight would have prevented the FCS problem, it is clear that the problem would have been recognized and remedial actions would have been taken sooner.

Current law provides for $266 million of direct Federal financial assistance through FCA purchases of stock in FICBs, PCAs and BCs and through Treasury deposits in FLBs. In addition, ag banks and FCS institutions have legal authority to borrow from the Federal Reserve (all such borrowings must be collateralized), and deposits in most ag banks are insured by the FDIC. FmHA guarantees are available for loans to qualified borrowers.

QUESTION 3: Does the Government have an obligation to back the FCS as some of its bondholders may have assumed? How much financial assistance can and should the Federal Government provide to farm lenders under current law? Do the circumstances of the FCS warrant specific Federal assistance not provided to ag banks, other creditors in stress, or other institutions dependent on the farm economy?

ANSWER: Existing statute (12 USC 2155) provides that each FCS institution is fully liable on its obligations and on systemwide obligations and that "the United States shall not be liable or assume any liability directly or indirectly thereon." The Administration recognizes the vital role that FCS plays for the Nation's farmers and is alert to the need to maintain FCS as a privately-owned organization that is sensitive to market forces rather than to Government dictates. Thus, we have urged the Congress to take two actions as quickly as possible to help FCS solve its current problems and avoid future difficulties. First, FCS needs legislative authority to mobilize fully its substantial earned surplus ($5.5 billion as of September 30, 1985) to absorb operating losses and manage troubled loan assets. Second, we need to transform the FCA into an independent financial regulator that has the will and the tools to supervise FCS efffectively.

We do not believe that Federal financial assistance is necessary or appropriate at this time for FCS or other agricultural lenders or agricultural businesses. Federal financial assistance would be the wrong approach in the light of resources that are available to deal with the agricultural credit problem (see also the response to Question 2) and the Administration's proposals to restructure FCA and tc facilitate mobilizing FCS capital.

QUESTION 4: How much would the cost of credit to farmers differ if the Government gave financial assistance under current law, if it gave no assistance, or if it adopted different forms of assistance? If there is to be financial assistance legislation, how much difference would it make if Congress completes action early next session rather than this session?

ANSWER: FCS does not need Federal financial assistance at this time, and we doubt that there would be any noticeable difference in the interest rates that borrowers from FCS institutions pay on their loans if direct Federal financial assistance were provided. We understand that FCS institutions are maintaining interest rates on loans at relatively low margins to their average costs of funds in order to remain competitive with other institutions for high quality loans and that other financial institutions would be unwilling or unable to take on a much larger share of total agricultural lending.

Declines in market interest rates generally have more than offset the increase in the spreads between Treasury and FCS securities since September, when the markets began focussing on the FCS problems. Yet, the existing relatively low margin of profit on FCS loans, pressures on alternative agricultural lenders and the need to build FCS loss reserves to deal with problem loans have mitigated any downward impact on the rates paid by FCS borrowers.

It is important for the Congress to act quickly on the Administration's proposals to: (1) enable FCS to deploy its own substantial resources to solve its localized financial difficulties, and (2) reform and strengthen FCA. The President has decided that the Administration will further assess FCS' need for Federal financial assistance, but only if the Congress is willing to legislate the changes that we have proposed. The Administration is committed to a reassessment of the financial assistance question once the necessary reforms have been implemented.

QUESTION 5: Does the traditional 15 to 30 basis point spread between Treasuries and FCS bonds indicate that bondholders have been paid to bear some risk for holding FCS bonds? Should FCS, as a large financial institution that depends almost entirely on agriculture, be treated differently from commercial banks whose largest farm lenders are much more diversified and whose most agricultural-dependent lenders tend to be much smaller? If current FCS bondholders were to be required to "take a hit," would that raise the cost of borrowing for Federal agencies? If so, what would be the effects?

ANSWER: Interest rates on Treasury securities, which are the highest quality, most liquid securities in the world, serve as benchmarks for interest rates on securities of other issuers. FCS securities have been issued at higher yields than Treasury securities of comparable maturity, because they are somewhat less liquid than Treasury securities and because they are not backed by the full faith and credit of the United States. This is the case with the securities of the other sponsored agencies as well.

The sharp increase in the spread between FCS and Treasury securities in September, when the securities markets focussed on the FCS problem, in part reflected a loss in liquidity as investment managers reassessed their holdings of FCS obligations. There was a spillover effect at that time, in which yield spreads increased between Treasury securities and those of the other federally-sponsored agencies. In a sense, holders of outstanding FCS obligations have already taken a hit in that the prices of their bonds have not kept pace with the general increase in bond prices over the last several months. Spreads have narrowed somewhat since then, as FCS financial condition has become more clear and as discussions have proceeded regarding the Administration's legislative proposals to strengthen the regulatory authorities of FCA and to mobilize FCS' substantial resources.

FCS is different from other agricultural lenders in that it issues its securities wholesale in the securities markets. In this connection, FCS has many ties to the Federal Government (such as use of the Federal Reserve as fiscal agent, exemption from regulation by the SEC, and exemption of interest on FCS securities from State income taxes) that give FCS securities advantages over securities of private issuers that are translated into lower borrowing costs. FCS ties to the Government were granted by the Congress, because FCS has the public purpose of channeling funds from the securities market into agriculture. In this respect, FCS institutions complement the credit extended from banking institutions which obtain their funds from various deposit sources.

QUESTION 7: How do the current supervisory/regulatory powers of FCA differ from those of the FDIC, Comptroller, etc.? If FCA had already had such powers, how much difference would that have made to recent FCS performance?

ANSWER: The Federal financial institution regulators have authorities to require standardized accounting and financial reporting practices, to specify operating guidelines such as capital requirements, and to require compliance with their requirements. Moreover, the chairmen of the other financial institution regulators are appointed directly by the President. FCA does not have authorities, such as cease and desist power to enforce its requirements, nor has FCA required standardized financial reporting by FCS institutions until recently. The Administration's proposal would strengthen FCA's regulatory and enforcement powers and would provide FCA with independence from FCS that it needs.

Even if FCA had had powers comparable with those of the other financial institution regulators, it is not clear that the current situation would have been avoided; however, the extent of problem loans would have been known sooner. Many commercial banks that are under Federal regulation are experiencing financial problems as a result of farm lending, and some probably will have to write down large volumes of loans.

QUESTION 10: What is the relationship between the FCS and ag banks in terms of competition, complementarity, and bond holding? How would assistance to the FCS but not ag banks affect that relationship?

ANSWER: The competitive relationship between FCS institutions and agricultural banks depends on the type of loans, structure of local lending market, State banking regulations, conditions in national financial markets and a number of other factors. Whereas commercial banks and PCAs generally are very competitive in providing short-term credit, commercial banks generally do not choose to compete as keenly with the Federal Land Banks (which are the largest holders of farm mortgages) for long-term loans.

On the liability side, FCS and banks each have advantages that tend to result in these institutions complementing each other. FCS institutions tap the national securities market on a very large scale, often borrowing for longer terms, while banks rely largely on shorter term deposit sources, such as demand and time deposits and negotiable CDs. While FCS benefits from ties with the Federal Government that make its securities attractive to investors, commercial banks have Federal deposit insurance and can borrow from the Federal Reserve System, which tend to lower their borrowing costs.

On the asset side, banks are more diversified than FCS institutions, which results in their ability to charge different profit margins on different types of loans and to spread risk-taking. Banks usually charge interest rates on short-term farm and business loans that reflect their marginal cost of funding the loans. FCS institutions price their loans based on their average cost of funds, rather than attempting to pair the maturities of assets and liabilities. If FCS were to change to the marginal pricing concept, the countercyclical lags would be eliminated which hold FCS interest rates higher on the downside of an interest rate cycle, resulting in decreased competitiveness with banks at such times.

It should be noted that available data on purchases of FCS securities on original issue indicate that banks are major purchasers of FCS securities. Also, if FCS could not roll over its debt, it would have to liquidate loans, depressing the value of farm assets further. Moreover, FCS owners are farmer-borrowers, whose financial strength is important to the banks. Thus, the value of banks' portfolios is in large part reliant on the viability of FCS.

RESPONSES BY THE FARM CREDIT COUNCIL TO QUESTIONS SUBMITTED BY HON. JOHN J. LaFALCE

Q 1. Do farmers still require the Farm Credit System (FCS) and all its parts? Can they find alternative sources of long-and short-term credit such that the government need not worry about protecting the FCS?

A. The Farm Credit System was created by Congress to serve as a mechanism for channelling capital from Wall Street to American agriculture. This need still exists today. Indeed, as the depression in the farm economy worsens, the need becomes greater. One point upon which the Administration, Farm Credit Administration, Farm Credit Council and banking organizations seem to agree is that the continued viability of the Farm Credit System is required by the public interest. For example, the American Bankers Association has said that it "supports the survival of the FCS and recognizes that federal assistance may be necessary."

As indicated in the Chase Econometrics Study, a default by the System would increase interest rates charged to farmers by 300 to 450 basis points. In addition, the Chase Econometrics Study reveals that a System default would result in a void in the short-term farm production loan market of between $22 to $29 billion. It is also widely recognized that Federal Land Banks provide an indispensable function by making long-term real estate credit available to American farmers. Other commercial lenders, especially insurance companies, are retreating from this long-term real estate market.

Q 2. Could the FCS overcome projected financial problems without legislation providing federal financial assistance?

A. No.

Q. How much would giving the FCA powers comparable to the FDIC and mobilizing regional FCS funds for use nationally by themselves affect the staying-power of the FCS and its perception in the bond market?

A. While the dominant cause of the problems being experienced by System institutions is the extreme depression in the farm economy, we believe that enhanced examination and regulatory authorities for the Farm Credit Administration could enable the agency to more effectively ensure the safety and soundness of System institutions. It is doubtful that such actions alone would assure the bond markets of staying-power of the FCS.

Q. How much financial assistance can the Federal Government provide to the FCS and ag banks under current law through the Treasury, Federal Reserve, or any other agency?

A. Unlike the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation, the Farm Credit System has no line of credit from the Treasury. The Federal Reserve discount window is available to provide short-term liquidity for debt refinancing in an emergency basis for only a few days. The Governor of the Farm Credit Administration has a $266 million revolving fund for stock purchase in specific institutions. As is obvious, this fund has far less than the amount required for dealing with the current crisis.

Q 3. Does the government have an obligation to back the FCS as some of its bondholders may have assumed?

A. The government is said to have an "obligation" to back the FCS for several reasons. First, FCS institutions are government-sponsored corporations with Agency attributes operating under a Federal statute. Secondly, if the government fails to back the Farm Credit System securities, it would seriously disrupt the market for other agency securities. Thirdly, failure of the government to honor its "implicit guarantee," would result in disastrous consequences for American agriculture and the nation's economy as a whole. These consequences are detailed in the Chase Econometrics Study.

Q. **How much financial assistance can and should the Federal Government provide to farm lenders under current law?**

A. At present, the government can provide only very modest financial assistance to Farm Credit System institutions. As is indicated above, we believe that substantial financial assistance from the government is necessary to ensure the continued viability of the Farm Credit System.

Q. **Do the circumstances of the FCS warrant specific federal assistance not extended to ag banks, other creditors in stress, or other institutions dependent on the farm economy?**

A. The Farm Credit Council recognizes that other farm lenders and agribusinesses are experiencing severe economic stress. We do not oppose the government providing assistance to these enterprises. However, the Farm Credit Council believes that it is neither necessary nor desirable to provide other farm lenders with exactly the same type of assistance. The main type of assistance to agribusinesses such as feed, seed and fertilizer suppliers might be in the form of an effective farm bill. Commercial banks are not substantially involved in farm real estate lending and, as a result, the type of assistance appropriate for System institutions may not be appropriate for commercial banks. Commercial banks have not indicated whether they are willing to submit to the same requirements and conditions as System institutions in order to obtain financial assistance from the government. Finally, the FCS is charged to finance agriculture and cannot reduce its portfolio risk while being mandated by Congress to only finance agriculture.

Q 4. **How much would the cost of credit to farmers differ if government gave financial assistance under current law, if it gave no assistance, or if it adopted different forms of financial assistance?**

A. Under current law there is not enough provision for FCS financial assistance to influence the cost of credit to farmers. Without government financial assistance the cost of credit will rise by the amount of widened spread above Treasuries plus the cost of carrying non-accrual loans. The risk of default as illustrated by the Chase Econometrics Study indicates that, if the Farm Credit System defaults on its bonds, the interest rates paid by farmers and ranchers would increase by as much as 450 basis points in one year.

Q. If there is to be legislation, how much difference would it make if Congress completes actions early next session rather than this session?

A. We believe that Congressional action this year is necessary in order to bolster confidence among investors. If Congress fails to complete action this year, the least cost to farmers and ranchers who borrow from System institutions would be hundreds of millions of dollars in additional interest costs resulting from a lack of confidence by investors in System securities. This spread could widen. Alternatively, a panic reaction could result if investors believe that losses sustained by System institutions are too large and/or that the government does not implicitly guarantee System securities.

Q 5. Does the traditional 15 to 30 basis point spread between Treasuries and FCS bonds indicate that bondholders have been paid to bear some risk for holding FCS bonds?

A. The spread between Treasuries and Farm Credit securities, which has ranged between 5 and 15 basis points since 1980, could be interpreted as compensation for the difference between an implicit and explicit government guarantee.

Q. Should the FCS, as a large financial institution that depends almost entirely on agriculture, be treated differently from commercial banks whose largest farm lenders are much more diversified and whose most ag-dependent lenders tend to be much smaller?

A. The differences in treatment between Farm Credit System institutions and commercial banks involved in agricultural lending are based on a number of factors. First, as indicated, American agriculture is virtually the only client of the Farm Credit System. This statute based a limitation on the System and enhances the vulnerability of the System because, as indicated by Emanual Melichar of the Federal Reserve Board, even a relatively modest diversification of lending portfolio provides a significant protection to farm banks. Secondly, Farm Credit institutions are also proscribed by law from offering a wide variety of financial services now offered by commercial banks. A third difference between System institutions and commercial banks is that FCS is mandated to provide agricultural credit in all areas and at all times. Unlike commercial banks, System institutions cannot decide when to withdraw from agricultural credit markets simply because it is most profitable to do so. In summary, System institutions differ from commercial banks in a number of ways because of their unique federal charter as specialized lending insitutions.

Q. If current FCS bondholders were to be required to "take a hit," would that raise the cost of borrowing for federal agencies? If so, what would be the effects?

A. The Chase Econometrics Study (Economic Impacts of a Farm Credit System Default) concludes that other government-sponsored enterprises would be severely impacted if Farm Credit System security holders sustained a significant loss. The Chase Econometrics Study points out that "significantly higher borrowing costs" would result "not only because of the loss of their implicit Federal Government guarantee, but also because of the rise in interest rates." Chase acknowledges that the impact on Fannie Mae, Federal Home Loan Bank System and Freddie Mac would differ but concludes that the solvency of each of these agencies would be threatened by a Farm Credit System default. The Chase Econometrics Study goes on to conclude that the "loss of support from (other) agencies, the earnings problems of savings and loans and the increased risk of default raises mortgage rates by 290 basis points in 1986.

Q 6. What are the trade-offs between providing assistance to farm lenders rather than taking measures to raise the income of farmers?

A. The Farm Credit Council strongly supports efforts to enhance net farm income. We believe it deserves to be noted that the amount farmers pay in interest is a key factor in determining overall net farm income. Moreover, if the Farm Credit System is allowed to collapse, devastating consequences would result for American farmers and ranchers. Some of the consequences noted in the Chase Econometrics Study include:

* Almost 90,000 additional farm operators would have their loans foreclosed in the first year after default on System obligations.

* Interest rates paid by farmers would increase by as much as 4.5 percent in one year.

* There would be a shortfall in the amount of credit needed for agricultural production expenses between $22 and $39 billion.

Q 7. How do the current supervisory/regulatory powers of the FCA differ from those of the FDIC, Comptroller, etc.?

A. At present, the Farm Credit Administration is not authorized to impose intermediate supervisory/regulatory powers on Farm Credit System institutions. These intermediate level authorities which the Federal Deposit Insurance Corporation, the Comptroller of the Currency and other financial regulatory agencies possess include such things as: the authority to issue cease-and-desist orders, the authority to remove officers and directors and the ability to levy civil money penalties. FCA currently exercises supervisory "operational" powers in approving policies of operating units of the FCS inappropriate to an arms-length regulator.

Q. If the FCA had already had such powers, how much difference would that have made to recent FCS performance?

A. The Farm Credit Council does not believe that effective use of intermediate enforcement powers would have been sufficient to prevent problems developing in the Farm Credit System portfolio. This is because the root of the System's problem is the extreme depression in the farm economy.

Q 8. Does the current system of autonomous local cooperatives have advantages that would be lost if more authority is centralized nationally in the Farm Credit System and Farm Credit Administration?

A. The Farm Credit Council believes that the essential elements of the System's decentralized credit delivery system can and should be maintained. Moreover, the Farm Credit Council insists that farmer and rancher control of their cooperatively owned credit institutions must be maintained. At the same time, autonomy of local cooperative credit institutions cannot be allowed to threaten the viability of the System as a whole. In short, the challenge of the Farm Credit System is to retain as much grassroots input while making the needed adjustments in the structure to meet the challenges of today's marketplace.

Q 9. How many financially strong borrowers have been leaving FCS to find less expensive credit elsewhere?

A. Farm Credit System institutions have experienced a sharp drop in loan volume from $80.1 billion in September 1984 to some $72.7 billion in September 1985. It is impossible to quantify how much of this decline in volume is due to financially stronger borrowers leaving the System in order to find less expensive credit elsewhere or because of fears of having their "B" stock impaired. However, both details of portfolio trends in the Omaha and Spokane Districts substantiate the thesis that regular borrowers are leaving for the reasons cited. For example, the Spokane FICB indicates that its loan volume decreased by $504 million in the last twelve months primarily because of its "non-competitive" interest rate position.

Q. How much has this weakened the FCS?

A. The flight of the strong borrowers has had the most significant impact in the Omaha and Spokane Districts. However, other districts also have been weakened by this trend. If it continues, the viability of System institutions could be in question.

Q 10. **What is the relationship between the FCS and ag banks in terms of competition, complementarity, and bond holding?**

A. Farm Credit System institutions and commercial banks maintain close working relationships in a number of different ways. In regard to lending activities, commercial banks often maintain close working relationships with Federal Land Bank Associations which make long-term farm real estate loans. Production Credit Associations compete with commercial banks in making operating loans to farmers. However, commercial banks often maintain relationships with Federal Intermediate Credit Banks as "other-financing institutions." In addition, several commercial banks participate in loans with Production Credit Associations. Commercial banks also are linked with PCAs and other System institutions in that they own nearly 50 percent of System securities. Because of their substantial investment in System securities, it is estimated by Chase Econometrics that some 3,900 commercial banks would lose more than one-third of their capital if the System defaults on its bonds. The Chase Econometrics Study estimates the number of agricultural banks with inadequate capital would increase from 141 in March of this year to 957 if the System defaults on its bonds. Finally, Chase Econometrics estimates that a combination of loan losses and security losses would result in an increase of the number of agricultural banks with inadequate capital to 2,302 which is equal to 59 percent of all agricultural banks in the United States.

Q. **How would assistance to the FCS but not ag banks affect that relationship?**

A. As indicated above, agricultural banks have an interest in maintaining the viability of the FCS. In addition, the Farm Credit Council does not oppose providing financial assistance to agricultural banks. Assistance to the FCS would benefit commercial banks by stabilizing farm real estate markets, reassuring financial markets and avoiding a rapid transfer of agricultural credit demands.

Q. **How do the FCS and ag banks compare in their costs of obtaining money and lending it?**

A. Unlike commercial banks, Farm Credit System institutions obtain its loan funds almost exclusively on Wall Street. System institutions cannot accept deposits or obtain funds in a variety of other ways commercial banks normally do. At times, this statutory restriction places the FCS at a competitive disadvantage.

Q 11. How do the FCS and commercial bank lenders to farmers differ in terms of diversification of loans, sources and costs of funds?

A. As indicated above, FCS institutions, unlike commercial banks are prohibited by statute from diversifying their portfolio beyond agriculture, except in certain strictly limited respects. This means that 95 percent of System assets are interest sensitive which makes System institutions more subject to the vicissitudes of the agricultural economy.

Q. What is the relationship of rural banks to larger banks and money centers?

A. I would refer this question to spokesmen for the American Bankers Association and the Independent Bankers Association of America.

Q. Do they make a net transfer of funds out of rural America that is offset by the FCS bringing money center funds back?

A. Yes, this is the central reason why the Farm Credit System was established by Congress. The Farm Credit System continues to serve as a channel by which chronically credit deficit areas in rural America are provided loan funds from Wall Street.

Q. Have they drawn in funds from larger urban banks such that a series of rural bank failures would derivatively cause significant problems for larger banks?

A. I would refer this question to the representatives of the American Bankers Association and the Independent Bankers Association of America.

Q 12. In recent years, the FCS has developed a "Project 1995" strategy to become a stronger competitor. How does the proposed legislation fit within that strategy? What are the implications for farmers and other lenders?

A. Project 1995 proposed that the FCS must become more customer responsive. Assuring continued financing at reasonable cost with federal financial assistance is not inconsistent with this strategy.

Q 13. Why has the FCS doubled its ratio of operating expenses to oustanding loans since 1980?

A. The System's ratio of operating expenses to outstanding loans has not doubled. The System's ratio has increased from .0068 percent in 1980 to .0099 percent in 1985. This increase largely reflects the additional expenditures which are needed to deal with problem loans and other consequences of the deteriorating financial condition of agriculture. Moreover, when compared to the operating costs of comparable troubled lenders, the Farm Credit System's operating expenses are comparatively modest.

Q. How much do FCS salary increases account for this rise?

A. Farm Credit System institutions have been engaged in reducing salary expenses in a number of ways. There has been a reduction of nearly 2,000 employees of Farm Credit institutions which amounts to a substantial savings. Moreover, total salaries of Farm Credit Bank CEOs in 1985 is 12 percent less than in 1981 and 17 percent less than 1984.

Q 14. What has been the recent practices of the FCS and ag banks in their treatment of troubled loans -- in terms of both forbearance, restructuring, liquidation and recognition of such loans for accounting?

A. Farm Credit System institutions have been adhering to the forbearance policy of the Farm Credit Administration which is as follows: Recognizing the current plight of the Nation's farmers in which they have experienced declining prices in the face of mounting operating costs, the Federal Farm Credit Board pledges the fullest support of the cooperative Farm Credit System in doing what it can to assist hard-pressed member-borrowers while continuing to carry out the intent of Congress by maintaining a viable credit delivery system. The Federal Farm Credit Board reaffirms the System's long-standing policy of forbearance -- that is, sticking with a borrower so long as there appears to be a reasonable possibility for him to work out of financial difficulties and reestablish a fully viable farm business. In so doing, System institutions must be prepared to require that adjustments be made or disciplines exercised to help assure the borrower's ultimate recovery. Foreclosure or other such drastic action is to be avoided unless and until there is no reasonable alternative course of action remaining. In carrying out this policy, strong emphasis must be placed on appropriate loan servicing that will benefit the borrowers who are cooperative and making an honest effort to meet the conditions of the loan contract. It is recognized further by the Board that the desire to stay with farmers in difficulty must be balanced against the need to maintain the good reputation Farm Credit securities have in the financial market, thereby assuring the System's ability to raise loan funds. Since the Farm Credit System is a privately-owned institution, it has an obligation to all the farmers who own it to run a sound business and not put some borrowers in a position of subsidizing defaulting borrowers as a result of excessive interest and loan losses.

Thus, the Federal Farm Credit Board recognizes its obligation to protect the interest of the System borrowers--both present and future--as well as the interest of investors upon whom the System depends for loanable funds.

THE PROBLEMS OF FARM CREDIT

THURSDAY, NOVEMBER 14, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 9:30 a.m., in room 2128, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce, Representatives Kaptur, Levin, Carper, Shumway, Wortley, Bereuter, McCandless, and McMillan.

Also present: Representative Bartlett.

Chairman **LaFalce**. The Subcommittee on Economic Stabilization will come to order.

This is the third in our series of hearings on farm credit. At today's hearing, we will hear the perspective of the Farm Credit Administration who is responsible for regulating the Farm Credit System. However, it has been more involved in the operational decisions of the System than other financial regulators like the FDIC and Comptroller of the Currency.

At our hearing yesterday witnesses from both the administration and the Farm Credit Council testified in favor of restructuring the FCA to resemble the regulatory role of the FDIC. The two sides differed, however, as to how important such a change would make for perceptions of the FCS in the bond markets. The administration was confident that a restructuring of the Farm Credit Administration and the Farm Credit System would be enough to assure the bond markets while the Farm Credit Council insisted that additional financial backing is required.

The commercial banks have loaned approximately $40 billion to farmers. They typically have much more diversity among their borrowers than the Farm Credit System, although some small rural banks are heavily dependent on the farm economy. Ag banks—those that have more loans to farmers than the national average—comprise a majority of the banks that have been forced to close this year.

Commercial banks have a complex relationship with the Farm Credit System. They compete with the production credit associations in making short-term loans to farmers. On the other hand, they, by and large, do not compete with the Federal land banks and want their farm borrowers to have to pay as little interest to the land banks as possible. They also have an interest in the Farm Credit System not liquidating too rapidly and forcing down land prices further. Finally, commercial banks have bought almost half of the $70 billion in bonds issued by the Farm Credit System. As Farm Credit System bonds have been discounted in the secondary market there has been a decline in the value of commercial banks' assets.

Our three witnesses today come well equipped to discuss the issues before us. Donald Wilkinson is Governor of the Farm Credit Administration which regulates the Farm Credit System. Timothy Taylor is representing the American Bankers Association, and Bud Gerhart, the Independent Bankers Association of America.

Before we proceed to hear the three panelists, all of whom can take a seat at the table at this time, I would ask our ranking minority member, Norm Shumway of California, for any opening statement he may have.

Mr. SHUMWAY. Thank you, Mr. Chairman. I join you in welcoming our panel of witnesses today whose testimony will present another perspective of the farm credit crisis facing America. In that regard, it is a pleasure to have Governor Wilkinson, head of the agency charged with oversight of the country's primary farm lending entity, the Farm Credit System; and Mr. Taylor of the ABA and Mr. Gerhart of the IBAA representing the second major credit source to agriculture banks.

As we start the third of this subcommittee's hearings on the issue of agricultural credit, it is easy to see that the relentless slump in the farm economy is threatening literally to plow under farmers, the Farm Credit System and scores of this Nation's 4,500 farm banks.

During the last year, we have seen the agriculture economy take a plunge. From every indication, problems confronting this sector are getting worse rather than better. More importantly, the factors underlying the farmers' plight are now taking their toll on our financial institutions, whether they be the Farm Credit System or the so-called agriculture banks.

The lending community is only as strong as their customer lending base. Needless to say, financial troubles beget financial troubles. As the farm community has weakened, so has the stability and viability of the lending structure. Indeed, yesterday, this subcommittee heard that the Farm Credit System faces depletion of its earnings and loan-loss reserves and, ultimately, its shareholders' equity if Federal financial assistance is not forthcoming.

Further, as a funding source, the bond market is under fire because confidence in farm credit loans has been seriously undermined by the current state of affairs.

The ranks of the commercial agriculture banks have been considerably pared down as returns on equity have declined in proportion to the weakened state of the agriculture sector. Currently, agriculture banks occupy the top third of the FDIC problem list. As the number of their failures increases, tremendous strain is placed on the Nation's deposit insurance fund, and ultimately the entire financial system.

These are grim statistics with equally grim repercussions on our economy. In those instances where communities lose their PCA, Federal land bank or commercial bank, the impact is devastating not only for farmers and ranchers unable to obtain new lines of credit, but for the local business community as well. Whole communities are destroyed in the process.

Several solutions to this dilemma have been offered ranging from restructuring and self-help measures to direct financial assistance from the Federal Government. I believe America's agribusiness community—both borrowers and lenders—need to survive, but survival entails change and sacrifice on everyone's part.

Obviously there are no easy solutions. Hopefully today's witnesses can provide us with necessary insight to move in the right direction. Thank you very much.

Chairman LaFalce. Thank you.

Are there any other statements that any member of the committee wishes to make? If not, we will call as our first witness, Mr. Wilkinson.

STATEMENT OF DONALD E. WILKINSON, GOVERNOR, FARM CREDIT ADMINISTRATION, ACCOMPANIED BY MARVIN DUNCAN, SENIOR DEPUTY GOVERNOR; LARRY EDWARDS, DEPUTY GOVERNOR FOR SUPERVISION; AND FRED MEDERO, GENERAL COUNSEL

Mr. Wilkinson. Thank you very much.

Chairman LaFalce. We will put the entire text of your statement plus the appendices into the record, Mr. Wilkinson, and I would ask since it is so voluminous that you do attempt to summarize your remarks.

Mr. Wilkinson. I appreciate that, and I will attempt to summarize the statement.

I am Donald E. Wilkinson, Governor of the Farm Credit Administration. I will do as I have been invited; that is, to submit the lengthy statement and to summarize as briefly as possible the key points which I think will be of importance to the committee.

I have taken the liberty of having with me three key staff individuals because of the areas that we are covering today: our senior deputy Governor, Dr. Marvin Duncan, directly behind me; our deputy Governor for Supervision and Examination, Mr. Larry Edwards; and our general counsel, Mr. Fred Medero.

I would like to also indicate, Mr. Chairman, that last week, specifically Friday, we did submit to the Agriculture Committees of both the House and the Senate, the Farm Credit Administration's draft bill which includes the three basic parts which I will discuss briefly with you today.

The first of these is one which you have referred to already, and that is the examination of the Farm Credit Administration's enforcement powers to clearly define its role as an arm's length independent Federal financial regulatory agency.

The second aspect of our proposal is one that authorizes the Farm Credit System to engage in the pooling and managing of its resources and its distressed credit. The third part of our proposal determines a property level of public sector support for the Farm Credit System based on the public policy objectives it serves; in other words, the degree of financial assistance which may be needed.

I would like to assure you, members of the committee, and my colleagues at this table, that our proposal is an extremely austere one, unlike that which I think was discussed yesterday by the Farm Credit System itself.

We have come to the realization as has been evidenced in our testimony that a confluence of events and circumstances—many of which are beyond anyone's control—will stretch the financial resources of all agricultural lenders, and especially those of the Farm Credit System to their limit.

Any prospects for near term improvement or even cessation and the unrelenting economic decline in agriculture have disappeared. The most recent reports confirm further decreases in export markets, massive surplus production in 1985, practically ensuring low commodity prices for several years.

We see continued downward spiraling of collateral values, particularly land values and the prospect of considerable distortion in land prices, from the excess offerings as large groups of distressed farmers attempt to restructure their financial situations.

I would like to emphasize one point because as has been acknowledged in your earlier comments, Mr. Chairman, one part of the Farm Credit System—specifically the Federal land bank—is deeply involved in nearly half of the real estate financing for American farmers. Land is used as collateral. Land values, therefore, are important.

Between 1981 and 1985, U.S. farm real estate values declined about $151 billion, with over $100 billion of that drop occurring in the last year.

This erosion of real estate values greatly reduces the ability of all lenders, but especially the Federal land bank to collateralize loans to cover cashflow shortages. It also explains, perhaps more than any other factors, why farm borrowers and their lenders now face their most serious crisis since the Depression.

The problem focuses on the System because unlike the commercial banking industry, the largest share of its loan volume is in real estate mortgaging.

The effect of this then on the System in general and specifically on the Federal land banks is profound. The Department of Agriculture financings show that about $4 billion of land bank debts held by operators with debt-to-asset ratios between 70 and 100 percent, and with negative cash-flows.

Three and one-half billion dollars is owed by insolvent operators. If land values should fall another 20 percent from January 1985 levels within the next 2 to 3 years, the Farm Credit Administration estimates that a cumulative total of $13 billion of loans may become nonaccruing by the end of 1987.

Given past collateral recovery rates and future economic forecasts as a basis for loss projections——

Chairman **LaFalce**. How much did you say? Excuse me.

Mr. **Wilkinson**. $13 billion may become nonaccruing assets by the end of 1987.

The restructuring and liquidation of this $13 billion in loans could result in charge-offs of some $6 billion before year end 1987; $3 billion of that is now quite well identified.

Potential losses of this magnitude truly threaten the financial viability of the Farm Credit System, and this is why we truly believe contingency plans for financial assistance must be put in place and put in place as rapidly as possible. As we look ahead, FCA's analysis of the current projected financial condition of the System we believe that parts of that system are already nonviable.

The System's competitive position may be lost well before the damage is reflected in its balance sheets. This is true because any amount of capital is adequate only so long as investors in Farm Credit System securities think it is. Adverse trends in financial ratios are likely to result from continued deterioration in the agricultural sector, additional loan losses, and loss of the System's ability to attract and retain financially sound borrowers.

These trends threaten the System's ability to continue to sell securities well before the System's capital is lost. The System would likely be unable to fund itself and yet retain substantial financial resources if the financial markets lose confidence in the System's ability to manage its financial problems and become, therefore, unwilling to finance its maturing debt obligations.

The effects of a loss of market confidence would be devastating. The financial markets will be impacted with a major additional cost borne by other agency market entities and investors holding farm credit securities and other agency securities as well.

We have recommended, as I indicated in our bill, three specific proposals. The first of these is to enhance the role of the Farm Credit Administration as an arm's length regulator. To do this we would propose, first, to eliminate the statutory authority provisions authorizing and directing FCA to delegate some of its duties and powers to institutions within the System.

This is actually including the delegation of some of our examination authorities. This would require FCA to reassume direct responsibility for examination and for supervision of all system institutions. We believe this is the proper role for a financial regulator. Recent experience raises serious questions regarding the reliability of bank credit reviews during these stressful times.

Second, addressing the issue of intermediate enforcement authorities for FCA, the present tools available to the FCA are inadequate to ensure the safety and soundness of the financial institutions it supervises, the ones that it regulates, the ones it is examining.

We recommend the enactment of legislation establishing intermediate authorities specifically dealing with granting authority to issue cease-and-desist orders, temporary cease-and-desist orders, removal and suspension of officers and directors or other persons participating in the affairs of the farm credit institutions, and the authority to impose civil money penalties.

These authorities would be exercised by FCA pursuant to statutory provisions requiring that notice and an opportunity for a hearing be provided to the affected parties. If an order is issued, the affected party would also exercise rights to judicial review.

The third part of this additional authority would be to increase market discipline and accountability. Shareholders of the Farm Credit Administration, the owners, the borrowers, and themselves on one hand, and investors on the other hand have a right to accurate and timely information regarding the performance and condition of system institutions. Through appropriate disclosure and clear lines of accountability, the market and shareholders can effectively discipline system institutions. FCA has proposed regulations that would require banks and associations to improve the issuance of their annual reports, statements to stockholders and shareholders, the use of their annual meetings, the filing of conditions and performance reports.

Going now from the new authorities of the FCA to our expectations as we presented them in our bill, of changes within the Farm Credit System itself, we would propose this: we would propose that a Farm Credit System capital corporation be granted statutory authority to implement system self-help efforts. This entity, newly structured, would be capitalized by system funds, staffed by highly competent work out specialists.

The corporation's job would be to work out troublesome loans in a businesslike manner. This approach will allow the attention of the banks and their associations to return to the business of making sound credit available to American agriculture.

There are four key approaches, four key aspects to the use of a newly structured capital corporation within the System: One, it mandates that the System pool its capital base; two, it permits the system to pool the distressed loan assets from its hundreds of associations and its 37 banks; three, it facilitates restructuring and disposal of distressed assets; and four, it permits effective management of system capital and Federal assistance. These authorities would be carried out under the supervision and control of the Farm Credit Administration through the regulation and examining process. Within these parameters the System can better manage its own problems, but FCA would have the authority to intervene to protect the public interest.

As we look at alternatives for public sector support, the type of financial assistance, we believe that the decision on how much Federal financial assistance to provide to the Farm Credit System is truly one that can only be made by the Congress and by the administration based upon the public policy objectives it wishes to serve.

FCA's responsibility as a regulator is to recommend what it believes to be the most prudent course of action to preserve the essential elements of the Farm Credit System as a stable and a reliable source of competitively priced credit to creditworthy farmers, ranchers, and their agricultural cooperatives.

We would therefore outline for your consideration three alternatives very briefly, and in these alternatives we assume that Congress will move to provide FCA its enforcement authorities as an arm's length regulator, and that Congress will mandate that the System make the maximum use of its own substantial resources by augmenting the role and authorities of the capital corporation.

Option No. 1 would be no financial assistance, and it is my understanding, Mr. Chairman, that that was proposed yesterday. I would say to you that this approach at best will increase system funding cost and therefore farmer credit cost as investors demand an even higher risk premium on system securities, and at worst, this option will cause the ultimate liquidation of the Farm Credit System.

From a borrower standpoint, it increases uncertainty of credibility and raises the prospect of losses of borrower investment, B stock, in other words. It increases upward pressures on interest rates and downward pressures on land values. It offers no stabilization of that very serious issue of land and its value.

It also places tremendous pressure on the System institutions——

Chairman LaFalce. Could you try to conclude in the next several minutes, Mr. Wilkinson?

Mr. Wilkinson. I will.

It will place tremendous pressure on system institutions to liquidate and dispose of its assets.

The second alternative, as I attempt to summarize rapidly, will be our proposal, Mr. Chairman, and that is to provide a backup line of credit from the Treasury. This alternative would be a line of credit upon which the Farm Credit Administration uses its revolving fund, and, therefore, the System would draw on a line of some $5 billion.

We believe that this backup line of credit will ensure the continued availability of funds as far as the borrowers are concerned and will provide assurances to the investment community that if and when necessary, the Government does stand behind the farm credit securities.

This provides more than farm credit assistance. This enables the land banks to continue to be in there to provide land bank loans stabilizing, if at all possible, this important aspect as far as all agricultural creditors are concerned. The third alternative would be up front financial assistance as has been proposed by the System.

I have already used the term. We believe a prudent plan is essential, an austere plan, and this is why then, our proposal: One, presents the need for new authorities to FCA; two, a mechanism to consolidate the capital assets and the bad reserves or bad loans of the System; and three, proposes a backup line of credit of $5 billion.

Thank you very much.

Chairman LaFalce. Thank you very much, Mr. Wilkinson.

[The prepared statement of Mr. Wilkinson with appendixes follows:]

STATEMENT OF
DONALD E. WILKINSON, GOVERNOR
FARM CREDIT ADMINISTRATION

before the

SUBCOMMITTEE ON ECONOMIC STABILIZATION

of the

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

November 14, 1985

I. INTRODUCTION

Mr. Chairman, the financial condition of the Farm Credit System is critical. Changes are necessary to ensure that it can continue to fulfill its statutory mission and to minimize the possibility of a recurrence of this situation.

There are three areas in which action is necessary. First, expand FCA's enforcement powers and clearly define its role as an arms-length, independent Federal financial regulatory agency. Second, mandate that the System engage in self-help by pooling and managing its resources and distressed credit. And third, determine an appropriate level of public sector support for the System based upon the public policy objectives it serves.

We have come to the realization that a confluence of events and circumstances, many of which are beyond anyone's control, will stretch the financial resources of the System to their limit. Any prospects for near-term improvement or even cessation in the unrelenting economic decline in agriculture have disappeared. The most recent reports confirm further decreases in export markets and massive surplus production in 1985, practically ensuring low commodity prices for several years. We also see continued downward-spiraling of collateral values, particularly land values, and the prospect of substantial distortions in land prices from excess offerings as large groups of distressed farmers attempt to restructure their financial situations.

The challenge we face is to halt the decline and to stabilize the agricultural sector while preserving the essential elements of a farmer-owned cooperative lending network that serves the national interest.

II. HOW DID IT HAPPEN?

A. Where Agriculture is Today

Agriculture is currently undergoing an immense financial adjustment in response to a number of unfavorable -- and unanticipated -- events that have bombarded the industry since the late 1970s. Although the general economy has enjoyed a strong expansion during the past 2 1/2 years, the farm sector has been staggered by a mixture of secular problems that have reemerged after a brief respite in the 1970s and by some striking new problems. Because of these problems, agricultural exports have slumped, asset values have declined, and farm income has stagnated at levels inadequate to service some of the debt incurred by some farmers during the expansion of the 1970s. Thus, farm-business failures have increased dramatically from the low levels of the previous 2 decades. Furthermore, these problems have spilled over into rural communities. Most businesses serving the farm sector, regardless of geographic region, have encountered reduced sales and sagging profits. And as we know, the financial stress problems in agriculture have been particularly evident among rural lending institutions.

B. How Agriculture Got There

Three factors account for much of the financial stress that currently exists in agriculture.

1) The first is the erroneous expectation shared generally by farmers, lenders, and policymakers that the environment of the 1970s would continue well into the future. Certainly, the ebullient events of this decade convinced many people that the traditional problems with excess production capacity, slow demand growth, and stiff export competition were finally resolved. These views were given credibility by many expert forecasts. Scarcity rather than surplus was to be the new norm. The prospect of strong export growth and rising land values encouraged many farmers to expand their operations. Because agriculture is a capital-intensive industry, heavy borrowing was required to accomplish this goal.

   Even today, there are those who do not yet realize that this expectation is a false one. We are not simply in a temporary downturn. American agriculture is undergoing a major structural adjustment.

2) The second factor was the inflation psychology that gripped investors both here and abroad. Farmland, like many other real assets, was viewed as a store of value against inflation and became a speculative investment for some. The expectation that land would continue to appreciate pushed values to

levels that were totally unrelated to and inconsistent with its income-generating capacity. While some recognized this as an imprudent business practice, no one could forecast with certainty that inflation would be brought under control, or the timing of it.

While it is easy to criticize these credit decisions today, it should be noted that the tripling farm debt between 1970 and 1980 was in line with most of the indicators used to measure creditworthiness. For example, farm real estate assets also tripled during the decade, increasing from $215 billion in 1970 to $755 billion 10 years later. In addition, net farm income was generally favorable in the 1970s, marked by peaks of $34.4 billion in 1973 and $32.3 billion in 1979. Because of these strong income levels, the returns to equity from income in the farm sector performed well during the decade, averaging about 4.5 percent per year even with the sharp expansion in debt financing compared to 3.4 percent per year during the 1960s. Agriculture started the decade with conservative leverage overall, and it ended the decade nearly as conservative overall. Therefore, the problem of the 1970s was not that farm debt expanded too rapidly; the problem was that too much of the debt fell into too few hands.

3) The third factor was the combination of macroeconomic policies used to achieve inflation control. First was the abrupt change in monetary policy that occurred in 1979 and the deregulation of financial institutions in 1980. The

Federal Reserve permitted interest rates to rise as they may to slow the growth in the money supply to wring the inflationary spiral out of the economy. Deregulation added to interest-rate pressures as banks competed more aggressively for a limited supply of funds with new instruments that offered investors higher yields. Second was the simultaneous following of an expansive fiscal policy that necessitated both more stringent and more prolonged monetary restraint to deal with inflation.

The unprecedented increase in interest rates during the 1979-81 period accomplished the intended purpose; the back of inflation was broken more completely and rapidly than many thought possible. The annual rate of increase for the GNP deflator fell from 9.6 percent in 1981 to just under 4 percent in 1984. Although agriculture has benefited significantly from less inflation, it also suffered from major undesirable side effects. The high foreign exchange value of the dollar worsened immediate impacts of demand curtailment, while high real interest rates speeded the disappearance of inflation- induced investment. Expected income growth did not materialize and jeopardized the basis for more highly leveraged borrowers. Sharp declines in commodity prices and asset values have reduced repayment capacity and have eroded the credit quality of agricultural loans.

The rest of the story is well known. Between 1981 and 1985, U.S. farm real estate values declined about $151 billion, with over $100 billion of that drop occurring in the past year. This erosion of real estate values greatly reduces the ability of lenders to collateralize loans to cover cash-flow shortages. It also explains, perhaps more than any other factor, why farm borrowers and lenders now face their most serious crisis since the Depression. The problem focuses on the System because, unlike commercial banks, the largest share of its loan volume is in real estate mortgages.

C. The Financial Dilemma Facing Farmers

The dimensions of the financial stress problem of farmers have been widely chronicled by the press and academia over the past year. In addition, the U.S. Department of Agriculture (USDA) has used census information and results from cost-and-returns surveys to develop an excellent profile of the financial stress problem. We believe that this information accurately portrays the seriousness of the situation.

USDA reported that about one-half of the Nation's farm operators had negative cash-flows in 1984. Approximately $50 billion of farm debt is held by operators with both a negative cash-flow and a debt-to-asset ratio over 40 percent, which may be a good indication of the magnitude of the financial problem. Given the events of 1985 regarding bumper crops, falling exports, and low commodity prices, the figure can only be growing. While some analysts suggest the USDA measures of cash-flow are overly strict, conditions have deteriorated during 1985. Further, based on an examination of production credit association (PCA) data, we believe that most operators with debt-to-asset ratios above 25 percent are probably experiencing stress, especially those from the Midwest and Great Plains.

According to USDA, of the $50 billion in troubled debt, about $13 billion is held by operators with debt-to-asset ratios between 70 and 100 percent, while another $11 billion is held by those who are insolvent -- their ratios are above 100 percent. Therefore, $24 billion of the debt was probably at or approaching nonaccrual status on January 1, 1985. Farm Credit Administration staff has made projections of the likely increases in troubled debt under a pessimistic outlook for commodity prices and asset values. Based on our assumptions, the amount of troubled debt in the total agricultural sector could increase to almost $35 billion by the end of 1988 ($14 billion in the 70-100 percent category and $20.5 billion in the insolvent category).

The effect of this situation on the System in general and the Federal land banks (FLBs) in particular is profound. The USDA figures showed that about $4 billion of FLB debt is held by operators with debt-to-asset ratios between 70 and 100 percent and negative cash-flows, and $3.5 billion is owed by insolvent operators.

If land values should fall another 20 percent from January 1985 levels within the next 2-3 years, FCA estimates that a cumulative total of $13 Billion of System loans may become nonaccrual by the end of 1987. Given past collateral-recovery rates and future economic forecasts as a basis for loss projection, the restructuring and liquidation of $13 billion in loans could result in chargeoffs of $6 billion. Potential losses of this magnitude threaten the financial viability of the System. This is why contingency plans for financial assistance must be put in place at this time. (See appendix A for 37 Bank financial statements as of September 30.)

The farm-debt problem reflects the transition that agriculture is undertaking as it adjusts to the realities of less inflation, deregulation in financial markets, and the full integration into changing world food and fiber markets. Agriculture and the institutions that serve it can respond to broad changes in economic conditions given enough time. It is unlikely that agriculture can avoid making these adjustments, given the restraints on the Federal budget. So public policies are needed to buy time to allow an orderly adjustment to take place. In the absence of appropriate policy, the transition costs to the farm sector and rural communities could be immense. One of the many casualties would appear to be the System.

D. Experience of Others

Financial stress in agriculture is affecting the commercial banking sector as well. Their situation compares to the PCAs, which have also experienced significant losses. But the potential problem is less in total than the FLB exposure to dropping land values. Close to 400 agricultural banks are on the Federal Deposit Insurance Corporation's problem bank list. In the first half of the year, commercial banks charged off $520 million in farm production loans, up 85 percent from the first half of 1984. On June 30, total nonperforming loans at agricultural banks were 7.3 percent of the total portfolio, compared to 5.7 percent a year earlier. Nonaccrual loans were 5.2 percent of all loans at these banks, up from 3.8 percent last year. These difficulties result in a growing number of bank failures. Of the 82 bank failures so far this year, 49 have been agricultural banks. This figure already exceeds the total number of failures for all of last year when 78 banks failed, of which 32 were agricultural. From this information, it is clear that financial stress has permeated all lending institutions, and those with a large proportion of their portfolios in agricultural loans are no doubt retrenching.

As of January 1985, the situation facing the System appeared to be manageable within its own resources. Indeed, results of the USDA's 1984 Farm Costs and Returns Survey as enhanced by the Federal Reserve, showed that commercial bank loans were in slightly weaker hands than borrowings from the System, while as expected, the FmHA had the highest portion of loans to vulnerable farmers (see appendix B). What distinguishes the financial condition of the System today from the commercial banking sector is the rapid decline in land values and the System's domination of the farm real estate mortgage market. It now appears that

1985 alone will see land prices down nationwide as much as 10 percent; this on top of a 19-percent decline since 1981.

E. Looking Ahead in the System

Based upon FCA's analysis of the current and projected financial condition of the System, parts of it are already nonviable.

The System's competitive position may be lost well before the damage is reflected on its balance sheet. This is true because any amount of capital is adequate only so long as investors in System securities think it is. Adverse trends in financial ratios are likely to result from continued deterioration in the agricultural economy, additional loan losses, and loss of the System's ability to attract and retain financially sound borrowers.

These trends threaten the System's ability to continue to sell securities well before capital is lost. The System would likely be unable to fund itself and yet retain substantial financial resources if the financial markets lose confidence in the System's ability to manage its financial problems and become unwilling to refinance its maturing debt obligations.

The effects of a loss of market confidence would be devastating. The financial markets will be impaired with major additional cost born by other agency market entities and investors holding FCS and other agency securities.

The System is faced with a dilemma in trying to generate earnings and reserves for losses in order to halt these financial trends and retain funding capacity. The necessity is to charge higher interest rates to generate revenues necessary to meet the cost of carrying nonperforming loans and writing off losses. But higher rates exacerbate borrower flight as quality loans are refinanced at lower commercial credit rates. In addition, borrowers may leave because of the risk of loss of their equity investment in association stock, should the association fail. Those who cannot find alternatives, especially those with the weakest financial position, are further stressed by paying higher interest rates.

Compounding the System's problems is the fragmentation of its financial structure vis-a-vis its centralized fund-raising activity. The 37 System banks are jointly and severally liable to repay their consolidated notes and bonds. This access to the Nation's money markets is ensured in part through the combined financial strength and repayment record of the 37 banks. Yet, managing the capital and retained earnings of all 37 banks to maintain investor confidence and meet maturing obligations has been difficult. At best, negotiating necessary loss-sharing agreements has been time consuming and costly. And the threat always exists that one or more institutions may balk at approving them.

III. SOLVING THE PROBLEM

As I mentioned at the outset of my testimony, there are three actions that Congress must take to solve the problem. First, expand the FCA's enforcement powers and clearly define its role as an arms-length, independent Federal financial institution regulatory agency. Second, mandate that the System engage in self-help by pooling and managing its resources and distressed assets. And third, determine an appropriate level of public sector support for the System based upon the public policy objectives it serves.

A. The Role of FCA as Arms-Length Regulator

Once changes are made to FCA's statutory role as a Federal financial regulatory agency, then we can proceed to consider Federal assistance to the System with assurance that the public interest will be protected. Those changes are (1) improve the checks and balances on associations and banks; (2) enact enforcement authorities for FCA to correct unsafe and unsound banking practices; and (3) increase market discipline through accountability of management to stockholders.

Last week, we submitted legislation to the respective chairmen of the House and Senate Agriculture Committees that would extensively amend the Farm Credit Act (Act) of 1971, as amended, to reorder the FCA and equip it to meet the challenge of protecting the public interest. We take this public interest to include the protection of investors and stockholders in System institutions, as well as borrowers both now and in the future.

In making the following recommendations, we recognize the need to enhance our independence as a Federal financial regulatory agency. This recognition is based upon three assumptions. First, the public interest and that of the System do not always coincide in the short term. Insofar as the FCA is concerned, the public interest is paramount. Second, the FCA cannot guarantee the ultimate success or failure of the individual institutions of the System. This accountability lies with those who own the System through their elected boards of directors. And third, providing leadership and direction is fundamentally incompatible with the responsibility of regulating, examining, and supervising the System. The System must either provide its own leadership focus or operate without it.

1. Improve Checks and Balances on Banks and Associations.

FCA proposes to eliminate the statutory provisions authorizing and directing FCA to delegate its duties and powers to institutions of the System. This would require FCA to reassume direct responsibility for examining and supervising all System institutions. We believe this is the proper role for a Federal financial regulator. Recent experience raises serious questions regarding the reliability of bank credit reviews in stressful conditions.

The remaining authority of FCA will be governmental authority that should not be delegated to private institutions. This change is consistent with the overall purpose of the legislation we propose, which is to affirm and clarify the role of FCA as a financial institution regulatory agency and the role of System institutions as privately owned lenders.

The banks should still retain present statutory controls over the actions of the associations that are consistent with a principal/agency relationship with respect to Federal land bank associations (FLBAs), and a debtor/creditor and sole-source relationship with respect to PCAs. Of course, System institutions would be expected to continue to conduct their own internal audits.

2. Intermediate Enforcement Authorities

The present enforcement tools available to FCA are inadequate to ensure the safety and soundness of the financial institutions it supervises, regulates, and examines. Supervision by persuasion has proven ineffective.

Presently, FCA's enforcement authorities are designed to attack problems after the fact — "upon default" or after an association has "failed to meet its obligations." FCA's approval authorities permit it to attempt to forestall problems at the outset, but at the price of injecting itself into the management decisionmaking process of System institutions. There currently is no intermediate enforcement authority to correct situations as they develop.

We recommend the enactment of legislation establishing intermediate enforcement authorities for the FCA comparable to those possessed by other Federal financial regulatory agencies. These authorities will permit FCA to stop or alter a course of action that the regulator believes is unsafe, unsound, threatens the strength and stability of a financial institution, or violates the law, rules, or regulations.

Specifically, we request that FCA be granted authority to issue cease-and-desist orders and temporary cease-and-desist orders, remove or suspend officers, directors, or other persons participating in the affairs of institutions, and impose civil money penalties. These authorities would be exercised by FCA pursuant to statutory provisions requiring that notice and an opportunity for a hearing be provided to affected parties. If an order is issued, the affected party could also exercise rights to judicial review.

In February of this year, we transmitted to the respective chairmen of the House and Senate Agriculture Committees FCA's proposed legislation regarding these enforcement authorities. Since that time, the proposal has been addressed by interested parties at seven separate hearings before the House and Senate.

Based upon testimony presented at those hearings and after extensive negotiations, we recommend certain modifications to what we proposed last February. There are a number of substantive changes between the enforcement powers provisions contained in the legislation we have just submitted and provisions previously introduced in the Congress (Section 8 of S. 1598, Section 8 of H.R. 2609, and S. 466).

- Previous bills authorize enforcement proceedings against officers and directors who had "negligently" disregarded the safety and soundness of the institution. Today's bill would establish a higher standard for such actions by requiring a demonstration of "gross negligence."

- Previous bills would not require that hearings relating to enforcement matters be held in private. Today's bill would provide that such hearings would be private, except when the FCA determines that a public hearing is necessary to protect the public interest.

- Previous bills provide two bases for the imposition of civil money penalties: a) the violation of a final cease-and-desist order; or b) the violation of any provision of the Act or any FCA Regulation. Today's bill would limit the authority of FCA to impose civil money penalties to situations involving the violation of cease-and-desist orders.

- Today's bill would eliminate a provision contained in previous bills that would authorize FCA to revoke the charter of an institution if its directors had knowingly violated or permitted the violation of any provision of the Act.

- Previous bills authorize the imposition of temporary cease-and-desist orders when the activity would cause a substantial dissipation of assets or would be likely to seriously weaken the financial condition of the institution. Today's bill establishes a lower threshold for action by deleting the words "substantial" and "seriously."

- Today's bill contains a new provision that authorizes the Governor to define what constitutes an unsafe or unsound practice on an individual basis as that term is used in each enforcement proceeding.

- Today's bill contains a new provision authorizing the Governor to appoint a person to replace an officer who has been suspended or removed until judicial review of the removal is completed or until the board of the institution appoints a successor who has been approved by the Governor.

3. Increase Market Discipline and Accountability

Shareholders and investors have a right to accurate and timely information regarding the performance and condition of System institutions. Through appropriate disclosure and clear lines of accountability, the market and shareholders can effectively discipline System institutions.

FCA has proposed regulations that would require banks and associations of the System to issue annual reports and information statements to shareholders before annual meetings and to file reports of condition and performance with the FCA in accordance with prescribed accounting formats. In addition, we have designated in those proposed regulations reports to shareholders and specific portions of the reports of condition and performance as public information.

We firmly believe that shareholders of System institutions should receive accurate and timely information before electing directors so as to encourage more shareholder participation in the affairs of their institutions and to hold directors and management accountable for their actions. System banks and associations now report to their shareholders annually, but there are no standards for the form, content, and distribution of such reports. We have proposed that each System bank and association be required to issue an annual report to its shareholders within 90 days of the end of the fiscal year and to transmit a statement containing information specified in the regulation to shareholders at least 15 days before annual meetings at which directors are to be elected. The reports would be filed with FCA and available for public inspection.

The annual reports of System banks and PCAs would include financial statements audited by certified public accountants, including a copy of the accountant's opinion.

A copy of the proposed regulations and a complete description appears in the August 27, 1985, Federal Register beginning at page 34711.

Further obscuring accountability within the System are a number of statutory prior approval authorities that are vested in FCA. Such authorities are fitting of a program administrator. But for a financial institution regulator, they have the effect of injecting the regulator into the day-to-day management decisions, which are more properly the prerogatives of institution management.

We therefore propose a number of amendments to delete certain specified functions that are not consistent with FCA's role as a financial institution regulatory agency and that are more appropriately handled by the individual System institutions. The amendments also specify that when FCA is required by statute to approve transactions or activities, such approvals can be given through regulations. Such regulations would grant approval on the basis of the institution's satisfaction of or compliance with standards and criteria contained in the regulations.

Specifically, we propose to eliminate the authority for FCA to approve 1) the salary scale for employees of System institutions and the compensation of the chief executive officers of such institutions; 2) special assignment days in excess of 30 for district directors; 3) PCA lending standards, which are prescribed by the district Federal intermediate credit bank (FICB);

4) individual issues of System securities and execution of consolidated and Systemwide obligations (although FCA should retain authority to approve classes of securities and regulate their issuance).

We propose strengthening FCA's authority to regulate the preparation by System institutions and dissemination to stockholders and investors of information on the financial condition and operations of System institutions.

In view of this new authority, we propose to eliminate a number of specific powers, including the power to (1) coordinate the activities of banks in making studies of lending standards, the approval of standards, and other similar activities; (2) prescribe loan-security requirements and the loans that can only be made through prior approval; (3) coordinate, assist, and provide services associated with the effective management of System institutions; (4) prepare and disseminate information to the general public regarding the System and the merits of its securities; and (5) execute Systemwide or consolidated securities on behalf of the System institutions.

B. How The System Can Help Itself to Solve Its Problems

Losses in the System are growing at a rapid rate and threaten to overwhelm its substantial reserves and its ability to deal with problems internally.

While the System faces a potential liquidity crisis, it still retains considerable financial resources.

Because of the turmoil in the agricultural economy, many System institutions are spending the majority of their time servicing their distressed loan portfolio, rather than meeting the needs of creditworthy farmers. Given their traditional orientation toward loanmaking, rather than collecting and restructuring, System banks and associations are often ill-equipped to manage effectively a highly distressed loan portfolio, making a bad situation worse.

We propose, therefore, that the Farm Credit System Capital Corporation (FCSCC) be granted statutory authorities to implement System self-help efforts. Capitalized by System funds and staffed by highly competent workout specialists, the FCSCC's job will be to work out troubled System loans in a businesslike manner. This approach will allow the attention of the banks and associations to return to the business of making sound credit available to American agriculture.

There are four key aspects to this approach: (1) it mandates that the System pool its capital base; (2) it permits the System to pool its distressed loan assets; (3) it facilitates the restructuring and disposal of distressed assets; and (4) it permits effective management of System capital and Federal assistance. These authorities would be carried out under the supervision and control of FCA through the regulating and examining process. Within these parameters, the System can manage its own problems but FCA would have the authority to intervene to protect the public interest.

The benefits of this approach will be immediate and direct to both System institutions and their member- borrowers:

- If debt markets can be reassured that the risk of investing in System securities is small, the interest expense to System borrowers can be contained and possibly reduced after distressed loans are transferred;

- A more stable System will be under less pressure to liquidate assets to generate cash, improving the market climate in many rural areas, improving confidence, and contributing to the stabilization of farm-asset values;

- Appropriate and expert handling of distressed System assets will optimize return and minimize losses within the distressed asset portfolio, accelerating recovery of the System and minimizing cost.

The financial markets are associating greater risk with System securities than ever before, and this is reflected in the interest-rate spreads over Treasury securities that these markets demand. Without immediate action to assist the System's efforts to deal with its problems, these higher borrowing costs will have to be passed on to its borrowers, further increasing pressure on farmers at a time when many are unable to bear the burden they already have.

Also, there remains the danger that market risk perceptions will worsen further and raise the specter of default by the System.

The concept of centralizing distressed assets in a specialized organization is not unique.

The System's experience in capital assistance and asset restructuring supports the view that centralizing distressed assets and their workout will help stabilize the rural economy and improve the ability of the System institutions to return to the business of making sound credit available.

The emphasis on the size of expected System losses tends to obscure the fact that the System retains a substantial cash-flow generating capability. Not only is the System a valuable national asset, one that should not be discarded, but if provided the resources to survive this stressful period, the System will have the opportunity to return to the purposes for which it was designed.

Self-help is an essential step to preserving the System's viability as an agricultural lender and intermediator of funds from the savings-surplus sectors of the economy to the savings-deficit farm sector. System default would have a devastating, costly, and long-lasting effect on the financial infrastructure of rural America.

Experience shows that the most effective way to address the growing crisis is to pool System resources and distressed assets in a single institution. This can be implemented by the System now, with some modification to the Farm Credit Act.

Timely self-help is essential to reassure nervous debt markets and System borrowers, contain borrower interest costs, and stabilize farm-asset values.

C. Alternatives for Public Sector Support

The decision of how much Federal financial assistance to provide the Farm Credit System is one that can only be made by Congress and the Administration based upon the public policy objectives it wishes to serve. FCA's responsibility is to recommend what it believes to be the most prudent course of action to preserve the essential elements of the Farm Credit System as a stable and reliable source of competitively priced credit to creditworthy farmers, ranchers, and their cooperatives.

We therefore will outline for your consideration three alternatives for public sector support. We assume in each alternative that Congress will act to grant FCA enforcement authorities and clarify its role as an arms-length regulator, and that Congress will mandate that the System make the maximum use of its own substantial resources by augmenting the role and authorities of the Farm Credit System Capital Corporation.

ALTERNATIVE ONE: NO FINANCIAL ASSISTANCE

This approach at best will increase System funding costs as investors demand an even higher risk premium on its securities, and at worst will cause the liquidation of the Farm Credit System.

From a borrower's standpoint, it increases the uncertainty of credit availability, and raises the prospect of loss of borrower investment (B stock), increases upward pressures on interest rates, and downward pressures on land values. It also places tremendous pressure on System institutions to liquidate and dispose of its assets to generate cash to cover maturing obligations.

If no form of Federal financial assistance is provided, the impact on the financial community will be significant as well. Other agency market borrowers will likely experience an increase in funding costs as uncertainty is introduced in agency markets. Holders of System securities will experience a marked loss in value of their portfolios.

Rural communities will feel the impact as more agricultural related businesses are closed. There will be increased stress on commercial banks as asset values are destabilized.

The government will feel the impact in terms of lost revenue base and increased pressures on the Farmers Home Administration and Commodity Credit Corporation to meet farmers' credit needs.

The benefits of this alternative is that it will keep the pressure on System institutions to establish efficiency of operation, make maximum use of its resources, and operate in accordance with a strict business plan.

ALTERNATIVE TWO: BACKUP LINE OF CREDIT

This alternative is to provide the Farm Credit System with a backup line of credit from the Federal government that can be drawn up to $5 billion through a modified Governor's Revolving Fund once the System's resources have been adequately committed. This approach will negate many of the undesirable effects of alternative one. We believe this kind of backstop would provide the necessary reassurance to the financial markets to ensure the continued availability of funds. This approach also keeps a desirable level of pressure on the System to establish greater efficiencies and maximize the use of its own resources in dealing with problems without pushing individual institutions into a crisis-management position. This alternative should also stabilize interest rates on a System basis and reduce them for some institutions; alleviate borrower concerns over the loss of credit sources; and encourage a more orderly process for managing distressed situations. Under this alternative, no taxpayer funds would be committed until the clear need to do so was evident.

ALTERNATIVE THREE: UPFRONT FINANCIAL ASSISTANCE

This alternative provides direct, upfront, financial assistance combined with a contingent line of credit. However, FCA is concerned with the immediate budgetary impact this approach would have. We are also concerned that it would reduce the System's incentive to increase operating efficiency.

In conclusion, we recommend the following congressional action:

1) Grant FCA expanded intermediate enforcement authority and clarify its role as the arms-length regulator of the Farm Credit System;

2) Mandate that the System use its own resources by establishing statutory authority for the Farm Credit System Capital Corporation; and

3) Establish an adequate backup line of credit to be drawn upon as the need is demonstrated.

Appendix A

Testimony of
Governor Donald E. Wilkinson
Farm Credit Administration

FINANCIAL CONDITION AND PERFORMANCE
FARM CREDIT SYSTEM
QUARTER ENDING SEPTEMBER 30, 1985

Material presented herein was compiled from reports of financial condition and performance filed with FCA by Farm Credit banks for the quarter ending September 30, 1985. The information presented is as reported by the banks and reflects all revisions to initial reports received through October 25, 1985. Because further revisions are expected, the information is considered preliminary and subject to change.

FCA has neither approved nor disapproved the September 30 reports of financial condition and performance filed by FCS banks with respect to conformity to applicable accounting and reporting standards.

Appendix A does not include information on the financial condition and performance of Production Credit Associatons. PCA financial reports for the period ending September 30, 1985 are due to be filed with FCA on October 31, 1985. FLBAs report to FCA on a semiannual rather than a quarterly basis.

FCA expects to publish its Report of Financial Condition and Performance of the Farm Credit System for the third quarter of 1985 on or about December 6, 1985.

Credit Conditions as of September 30, 1985

1. Several recent economic statistics suggest that the economy is entering a period of some acceleration in growth. The 3.3-percent growth rate in real GNP for the third quarter represents an improvement over the 1.1-percent average of the first half. However, the underlying fundamentals of the current economy do not appear to support strong growth.

2. The trade deficit has continued to rise. While the rise in July was less than in June, most of the difference was a temporary decline in imports. Over the rest of this year, trade deficits are likely to continue at or above their current level.

3. Firming of the economy has been reflected in stabilizing interest rates. Additional economic strength is likely to put some upward pressure on rates.

4. The dollar has been on a downward trend since early in the year, due primarily to lower U.S. growth and declining interest rates. The dollar might be expected to firm at the prospects of a somewhat stronger economy and higher rates. In concert with Germany, Japan, Britian, and France, the U.S. has launched a coordinated program to force the dollar down.

5. Record large U.S. feed grain production materialized during the third quarter, portending a 1985/86 carryout second only to that of 1982/83, double that of 1984/85, and triple the 1983/84 level. While other domestic crops did not have record harvests, production far exceeds anticipated use, meaning record buildups of stocks and continued downward pressure on prices.

6. Red meat output continued to exceed expected levels, keeping a lid on prices and causing losses for feeders. Financial stress has meant continued liquidations, and heavy slaughter weights in anticipation of near-term price recovery has delayed such improvement.

7. U.S. agricultural export prospects continued to weaken during the third quarter. Just ended fiscal 1985 saw the dollar value slip $6 billion to $32 billion and the tonnage drop 15 million to 129 million metric tons. Further significant drops in volume and value are likely in fiscal 1986 even if the dollar continues to weaken.

8. Farm income prospects among crop producers vary greatly depending upon enrollment in the government programs. Somewhat under half the grain producers having 70-75 percent of the base program acreage are enrolled and can expect maximum deficiency payments, while those not in the program will do well if they can receive the loan rate as the market price.

9. Federal Reserve Bank surveys covering the second quarter found farm land values declining an average of 4.6 percent in the Chicago district and near 7 percent for ranchland and nonirrigated land in the Kansas City district, but values were stable to slightly mixed in the Dallas district.

10. CCC lending on the 1985 crops is expected to be record large due to depressed market prices and fairly high proportions of the program acreages enrolled, and a relatively favorable interest rate.

11. Farmers Home Administration - FmHA completed fiscal 1985 with a record level of loan obligations coupled with an inordinately high rate of debt-servicing activity.

    a) Direct lending in the operating loan (OL) program amounted to a record $3.6 billion, far exceeding the original budget of $1.9 billion.

    b) FmHA's debt set-aside program, which allows for the deferral of up to 25 percent of FmHA debt for 5 years, provided assistance to 15,794 FmHA borrowers during fiscal 1985; another 29,296 borrowers had loans that were rescheduled or reamortized. Of those applying for assistance, 10,440 were considered to have adequate cash-flow without any servicing action, 21,539 were projected to have inadequate cash-flow even if they were granted all available servicing actions, and another 4,0[illegible] were rejected on the basis of decisions made by county committees.

    c) FmHA received only 656 applications for guaranteed loans under their Debt Adjustment Program (DAP). Most of the guaranteed loan activity occurred within FmHA's regular guaranteed loan program, as $1.1 billion in regular guaranteed operating loans was obligated during fiscal 1985, compared to $55 million in DAP guaranteed loans.

    d) As of September 1, 1985, nearly 82,500 FmHA farmer borrowers were delinquent in their scheduled payments, equal to 29.8 percent of active farmer program borrowers. The delinquency rate was slightly lower than a year earlier when 30.6 percent of farmer borrowers were delinquent.

    e) For the first 11 months of fiscal 1985 (October 1984 through August 1985), 4,391 FmHA borrowers discontinued farming operations due to financial difficulties, representing 1.5 percent of all active borrowers. Over the same period last fiscal year, 6,262 borrowers were discontinued. The number declined primarily because of a considerable reduction in the number of foreclosures.

12. Commercial Banks - Commercial bank farm nonreal estate loans outstanding at the end of the second quarter were seasonally higher than at the end of the first quarter. However, for the second consecutive quarter, outstanding loans were lower than a year earlier indicating that banks are continuing a more conservative farm lending pattern.

Insured commercial banks held $40.1 billion in outstanding farm nonreal estate loans on June 30, 1985, up $1.8 billion, or 4.6 percent, from March 31, but down $1.2 billion, or 3.0 percent, from a year earlier.

13. Contributing to this year-over-year decline is a trend of reduced farmer demand for operating loans, coupled with a borrower shift, both voluntarily and involuntarily, from commercial lenders to government sources of funds (particularly FmHA). The financial performance of agricultural commercial banks continued to weaken during the second quarter, causing banks to be more cautious in their farm lending practices.

a) NET CHARGEOFFS of farm production loans at all commercial banks totaled $520 million in the first half of 1985, equal to 1.3 percent of all such loans outstanding, and up by 80 percent over chargeoffs in the first half of 1984. Historically, the fourth quarter is the most active period for bank chargeoffs, so total chargeoffs for the year will easily exceed $1 billion, compared to $900 million in 1984.

b) LOAN DELINQUENCY RATES at agricultural banks continue to rise, indicating that future chargeoff rates are likely to remain high. At the end of the second quarter, total nonperforming loans at agricultural banks were 7.3 percent of the total portfolio, compared to 5.7 percent a year earlier. Nonaccrual loans, which is the most severely delinquent category of nonperforming loans, were 5.2 percent of all loans at these banks, up from 3.8 percent last year.

c) NET EARNINGS at agricultural banks have been severely hampered by rapidly rising loan losses and higher levels of nonperforming loans. Because of this deteriorating financial performance, 12 percent of agricultural banks reported a net loss for 1984, compared with an average of only 1 percent during the 1970s. Also, in 1984, 17 percent of all agricultural banks made loan loss provisions that exceeded 2.5 percent of yearend loans outstanding.

d) The number of agricultural banks on the FDIC problem bank list continues to rise. Although agricultural banks comprise 28 percent of all commercial banks, ag banks account for 37 percent of all problem banks. Of the 975 problem commercial banks, 363 have more than 25 percent of their loan portfolios outstanding to agriculture.

e) For a growing proportion of agricultural banks, higher levels of nonperforming loans have resulted in the failure of these institutions. As of September 24, 1985, 82 commercial banks had failed, of which 49 were classified as agricultural banks representing 60 percent of the total. In all of 1984, 78 banks failed and 32, or 41 percent, were agricultural banks.

14. FARM CREDIT SYSTEM.

Large provisions for loan losses, reflecting FCS exposure to deteriorating farm loan and economic conditions, dominated third quarter financial results reported by Farm Credit banks. On a combined basis, the 37 banks reported provisions for loan losses of $538.9 million which resulted in net operating losses of $592.5 million for the third quarter. Although the combined net worth of the 37 banks remained substantial at $8.543 billion on September 30, it declined $651 million during the quarter. Total net worth declined to 10.6 percent of assets from 11.2 percent on June 30. Problems with the FLB mortgage loan portfolio accounted for the bulk of the increase in the provisions for loan losses. Third quarter financial reports for the PCAs are expected to reflect continuing problems when they become available.

Provisions for loan losses are necessary to ensure adequate allowances for loan losses. Adequate allowances for loan losses reflect risk inherent in loan portfolios and represent their effective devaluation to conform with prevailing conditions.

Provisions for loan losses totaling $509.3 million, $24.4 million and $5.2 million were reported by the FLBs, FICBs, and BCs respectively for the quarter ending September 30. These provisions brought the combined allowances for loan losses to $915.6 million for the FLBs, $51 million for the FICBs, and $122.4 million for the BCs after deduction of current loan chargeoffs. Chargeoffs reported by the FLBs for the third quarter totaled $140.3 million, compared with $1.3 million for the FICBs and $11.1 million for the BCs.

Because provisions for loan losses are charged against current income, they resulted in significant operating losses for the FLBs and FICBs on a combined basis. As a group, the 37 Farm Credit banks reported net losses totaling $592.5 million for the quarter ending September 30. Operating losses of $560.1 million and $39.5 million were reported by the FLBS and FICBs, respectively, while the BCs reported net income of $7.1 million. Third quarter operating losses translated into annualized returns on equity of -39.4 percent for the FLBs and -7.9 percent for the FICBs. The third quarter net income of the BCs represented a positive return on equity of 2.4 percent.

Nonperforming loans reported by the Farm Credit banks continued to increase and totaled $10.633 billion on September 30 compared with $9.821 billion on June 30. The portion of total nonperforming loans comprised of nonaccrual loans increased dramatically during the period, rising from $2.013 billion on June 30 to $3.533 billion on September 30. The bulk of the increase in nonaccrual loans was reported by the FLBs with nonaccruals rising from $1.854 billion to $3.297 billion on the quarter.

Operating losses resulted in declines in the combined earned net worth of the FLBs and FICBs. FLB earned net worth fell from $3.256 billion on June 30 to $2.689 billion on September 30 on a combined basis. FICB earned net worth declined from $599.9 million to $563 million on the quarter. Declining loan volume reduced FLB capital stock from $2.773 billion to $2.671 billion. Total FLB net worth reported by the FLBs declined from $6.029 billion to $5.360 billion. Total net worth reported by the FICBs declined from $2.016 billion to $1.976 billion during the quarter. Total net worth reported by the BCs declined from $1.219 billion to $1.208 billion and was due primarily to a modest decline in capital stock.

a. FEDERAL LAND BANKS.

Assets of the twelve FLBs declined 1.72 percent during the third quarter of 1985. FLBs reported assets totalling $53.280 billion at Sept. 30, 1985, down $930.7 million on the quarter. The decline centered in loans outstanding, which fell $1.802 billion. Declining loan volume was offset partially by increases in accrued interest receivable, investments in securities and acquired property.

The FLBs posted a decline in total net worth for the quarter as both earned net worth and capital stock fell. Earned net worth declined $567.2 million, 17.4 percent, to $2.689 billion. Capital stock fell $101.7 million, 3.7 percent, to end the period at $2.671 billion. Liabilities declined by $262 million, 0.5 percent, ending the quarter at $47.920 billion.

On a combined basis, the FLBs reported net operating losses of $560.1 million after provisions for losses totalling $509.8 million. The losses resulted in a combined return on assets of -4.17 percent and a return on equity of -39.4 percent. Collectively, the FLBs operated with a net interest margin of 0.75 percent for the quarter.

At Sept. 30, the debt-to-capital ratio of the FLBs was 8:94:1 on a combined basis. Total net worth comprised 10 percent of total assets.

FLB nonperforming loans comprised 12.4 percent of loans outstanding at Sept.30, 1985. Nonperforming loans held by the FLBs totalled $6.098 billion of which $3.297 billion was nonaccrual. The FLBs reported chargeoffs on loans totalling $140.3 million during the third quarter. The net impact of chargeoffs and provisions for losses from income left the FLBs with $915.6 million in allowance for loan losses at Sept. 30.

b. FEDERAL INTERMEDIATE CREDIT BANKS.

Total assets of the twelve FICBs declined $128.8 million, 0.7 percent, to $18.032 billion during the third quarter of 1985. Total loans outstanding went down $469.3 million, 2.9 percent, to $15.733 billion. Loans to PCAs declined 410.5 million, 2.7 percent, to $14.878 billion. Loans to OFIs declined from $725.9 million to $699.0 million.

Aggregate FICB liabilities declined by $88.1 million during the third quarter, falling 0.5 percent to $16.057 billion. Capital stock reported by the FICBs declined $3.9 million, 0.3 percent, to $1.413 billion. Earned net worth declined $36.9 million, 6.2 percent, to $563.0 million. Total net worth declined $40.7 million, 2.0 percent, to end the quarter at $1.976 billion.

The FICBs reported net operating losses of 39.5 million for the third quarter after making provisions for loan losses of $24.4 million. The net loss for the quarter represents an annualized return on assets of -0.87 percent and a return on equity of -7.89 percent. Collectively, the FICBs operated with a net interest margin of 2.03 percent during the third quarter.

As of Sept. 30, 1985, the debt-to-capital ratio of the FICBs stood at 8.13::1 on a combined basis while total net worth comprised 11 percent of assets.

Nonperforming loans comprised 25.3 percent of FICB loans outstanding on Sept. 30. Some $3.983 billion of the $15.733 in FICB loan volume was nonperforming of which $104.7 million was in nonaccrual status. The FICBs reported loan losses totaling $1.2 million during the quarter leaving the combined allowance for loan losses at $51.0 million on Sept. 30, 1985.

c. BANKS FOR COOPERATIVES.

Assets of the thirteen Banks for Cooperatives declined $634.2 million, 6.3 percent,
during the third quarter of 1985, to $9.435 billion. Loans outstanding fell $592.1 million, 7.1 percent, to $7.751 billion.

Aggregate BC liabilities declined 7.0 percent on the quarter, to $8.228 billion. Total BC net worth fell 1.0 percent during the quarter, to $1.208 billion from $1.219 billion. Capital stock declined 1.3 percent to $832.4 million. Earned net worth declined slightly from $375.9 million to $375.1 million.

The BCs reported net income for the quarter of $7.1 million after making provisions for possible loan losses totaling $5.2 million. Net income translated to an annualized return on assets of 0.29 percent and a return on equity of 2.35 percent. Collectively, the thirteen BCs operated with a net interest margin of 1.58 percent on the quarter.

As of Sept. 30, 1985, the debt-to-capital ratio of the BCs was 6.81:1 on a combined basis. Total net worth represented 13 percent of assets.

Nonperforming loans accounted for 7.1 percent of BC loans outstanding at Sept. 30, 1985 with $552.1 million in nonperforming status and $7.751 billion in total loans. Nonaccrual loans accounted for $130.5 million of total nonperforming loans. Collectively, the BCs reported loan losses totaling $11.1 million for the quarter and ended the period with allowances for loan losses totaling 122.4 million.

Summary of Condition and Income
Components of the Farm Credit System
at and for the Quarter Ending September 30, 1985

1.

	Summary of Condition September 30, 1985				
	13 BCs	12 FICBs	12 FLBs	FLBAs(1)	PCAs(2)
	- - millions of dollars - -				
Loans - total principal	7,751.1	15,733.2	49,254.9		
Performing	7,199.0	11,749.6	43,156.5		
Restructured	14.4	612.5	10.3		
Other restructured & reduced rates	47.6	0	17.1		
Other high risk	359.6	3,266.4	2,773.7		
Nonaccrual	130.5	104.7	3,297.3		
Less: Allowance for losses	122.4	51.0	915.6		
Net loans	7,628.7	15,682.2	48,339.3		
Cash & investments in securities	1,519.9	1,733.0	2,041.4		
Net acquired property	6.3	13.2	674.7		
Other assets net of adjustments	280.4	603.9	2,224.6		
Total assets	9,435.3	18,032.3	53,280.0		
Total liabilities	8,227.8	16,056.6	47,920.3		
Capital stock & participation certificates	832.4	1,412.6	2,671.1		
Earned net worth	375.1	563.0	2,688.5		
Total net worth	1,207.5	1,975.7	5,359.6		

(1) FLBAs report to FCA on a semiannual basis rather than a quarterly basis. The next FLBA reports to FCA will be at and for the 6 months ending December 31, 1985.

(2) Quarterly PCA reports to FCA for the period ending September 30, 1985, are due in the agency on October 31, 1985.

Components may not add to exact totals due to rounding.

2.

Summary of Income and Expenses
Quater Ending September 30, 1985

	13 BCs	12 FICBs	12 FLBs	FLBAs(1)	FCAs(2)
	- - millions of dollars - -				
Total Interest Income	232.4	452.4	1,435.9		
Less: Total Interest Expense	194.4	364.1	1,339.1		
Net Interest Income	38.0	88.3	96.8		
Less: Provision for Loan Losses	5.2	24.4	509.3		
Net Interest Income after Provision	32.8	63.9	-412.5		
Plus: Other Income	1.0	76.4	3.2		
Less: Other Expenses	26.7	179.7	150.8		
Net Income	7.1	-39.5	-560.1		

(1) FLBAs report to FCA on a semiannual basis rather than a quarterly basis. The next FLBA reports to FCA will be at and for the 6 months ending December 31, 1985.

(2) Quarterly PCA reports to FCA for the period ending September 30, 1985, are due in the agency on October 31, 1985.

Components may not add to exact totals due to rounding.

3.

Additional Financial Information
at and for the Quarter Ending September 30, 1985

	13 BCs	12 FICBs	12 FLBs	FLBAs(1)	FCAs(2)
	- - Three Months Ending September 30, 1985 - -				
Return on assets (%)	0.29	-0.87	-4.17		
Return on equity (%)	2.35	-7.89	-39.35		
Net interest margin (%)	1.58	2.03	0.75		
Net chargeoffs on loans ($ millions)	11.1	1.3	140.3		
Capital-to-assets ratio	0.13	0.11	0.10		
Debt-to-capital ratio	6.81	8.13	8.94		

Source: Reports of financial condition and performance.

(1) FLBAs report to FCA on a semiannual basis rather than a quarterly basis. The next FLBA reports to FCA will be at and for the 6 months ending December 31, 1985.

(2) Quarterly PCA reports to FCA for the period ending September 30, 1985, are due in the agency on October 31, 1985.

Components may not add to exact totals due to rounding.

Table 4

FLB Loan Performance
September 30, 1985

	Farm Credit District												
	1	2	3	4	5	6	7	8	9	10	11	12	Total
						Percent of Total Loans							
1. Performing	96.5	95.2	92.5	81.8	84.3	88.5	85.5	84.6	82.5	98.0	88.7	88.3	87.6
2. Formally restructured	0	*	*	*	0	*	*	*	0.1	0.1	0	0	*
3. Informally restructured	0	*	0	0	0	0	0.2	*	0	*	0	0	*
4. Other High Risk	2.5	3.4	4.8	5.6	12.5	4.1	4.4	4.8	7.8	1.6	7.2	7.8	5.6
5. Nonaccrual	1.0	1.3	2.6	12.6	3.2	7.4	9.9	10.6	9.7	0.2	4.2	3.9	6.7
VOLUME ($ million)	995.8	2,184.3	5,315.2	4,319.7	2,753.3	4,884.0	7,251.3	5,574.4	4,968.0	2,764.7	4,596.3	3,647.9	49,254.9
						Percent of Loan Numbers							
1. Performing	98.1	97.3	96.4	94.4	96.9	95.2	93	91.9	93.1	98.5	93.8	94.5	94.8
2. Formally restructured	0	*	*	*	*	0	*	*	*	*	*	0	*
3. Informally restructured	0	*	0	0	0	0	0	*	0	*	0	0	*
4. Other High Risk	1.5	2.4	3.1	3.4	2.6	4.8	5.1	5.9	4.2	1.4	5.0	4.9	3.9
5. Nonaccrual	0.4	0.3	0.5	2.2	0.5	A	2.0	2.2	2.7	0	1.1	0.6	1.2
NUMBER (000)	17.3	35.6	90.6	61.6	35.2	58.7	87.8	68.9	63.2	39.4	23.9	38.9	621.2

* Less than 0.1 percent
A Not available
Percentages may not sum to 100.0 due to rounding.

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Table 6

FICB Loan Performance
September 30, 1985

	Farm Credit District												
	1	2	3	4	5	6	7	8	9	10	11	12	Total
						Percent of Total Loans							
1. Performing	99.8	85.2	66.8	99.7	97.8	87.9	71.6	18.5	73.2	91.4	80.9	51.3	74.7
2. Formally restructured	0	0	2.6	0.1	0	0	8.7	0	2.9	0	11.8	0	3.9
3. Informally restructured	0	0	0	0	0	0	0	0	0	0	0	0	0
4. Other High Risk	0	14.6	30.0	0	2.0	11.8	19.5	79.7	23.6	8.2	6.0	47.4	20.8
5. Nonaccrual	0.2	0.2	0.6	0.2	0.2	0.3	0.3	1.9	0.2	0.4	1.3	1.3	0.7
VOLUME ($ million)	604.31	715.9	1,515.7	1,424.7	711.1	1,079.6	2,702.7	1,472.9	939.3	1,102.4	2631.5	832.8	15,733.2

Percentages may not sum to 100.0 due to rounding.

Table 7

Banks for Cooperatives Loan Performance
September 30, 1985

	1	2	3	4	5	6	7	8	9	10	11	12	CBC	Total
	Farm Credit District													
Percent of Total Loans														
1. Performing	99.6	92.4	77.4	99.4	99.0	90.6	93.3	78.5	97.5	83.7	85.4	89.1	95.8	92.9
2. Formally restructured	0	0.1	0	0	0	0	0	0	0	5.8	0	0	0.2	0.2
3. Informally restructured	0	0	0	0	0	0	0	0.1	0	0.6	8.6	0	0	0.6
4. Other High Risk	0	5.0	15.9	0.3	0.2	8.8	6.3	20.0	2.1	6.1	0	10.3	2.5	4.6
5. Nonaccrual	0.4	2.5	6.8	0.3	0.8	0.6	0.4	1.4	0.4	3.7	6.0	0.6	1.6	1.7
VOLUME ($ million)	151.7	66.8	267.7	425.4	298.2	367.4	995.4	419.8	426.3	144.5	540.5	319.4	3,327.9	7,751.0
Percent of Loan Numbers														
1. Performing	99.0	44.48	80.6	98.7	98.2	95.2	95.7	90.6	97.6	84.4	97.4	90.9	93.9	94.5
2. Formally restructured	0	11.1	0	0	0	0	0	0	0	3.2	2.0	0	1.0	0.3
3. Informally restructured	0	0	0	0	0	0	0	0	0	1.3	0	0	0	0.1
4. Other High Risk	0	33.3	14.9	1.3	0.9	3.6	3.6	7.1	2.0	8.4	0	7.4	3.0	3.9
5. Nonaccrual	1.0	11.1	4.5	0	0.9	1.2	0.7	2.1	0.4	2.6	0.7	1.7	2.1	1.1
NUMBER (000)	105	9	67	301	217	248	704	436	461	154	153	175	99	3,129

Percentages may not sum to 100.0 due to rounding.

Exhibit 1-A.1

Federal Land Banks
Statement of Condition
Combined Totals

September 30, 1985
($ 000 Omitted)

Loans: Unmatured Principal	$ 45,340,695
Unmatured Extensions	19,468
Delinquent Principal and Advances	575,306
Loans in Process of Closing	22,092
Nonaccrual Loans	3,297,307
Accrued Interest Receivable on Loans	2,633,388
Gross Loan Items	51,888,257
Less: Allowance for Losses	915,640
Less: Deferred Proceeds of Loans	95,722
Less: Future Payment Funds	372,213
Less: Advance Payments	346,376
Less: Unamortized Loan Fees	19,143
Less: Unapplied Loan Payments	53,790
Net Loan Items	50,085,373
Cash	54,345
Investments: U.S. Government Securities (Par)	161,340
Securities Government Supervised Institutions (Par)	149,135
Other Securities and Federal Funds	1,683,548
Investment in DBC Bankers Acceptances (Par)	0
Unamortized Premium or Discount (Net)	-7,810
Unamortized Defer Gain/Loss Security Sales (Net)	870
Total Investment in Securities	1,987,083
Notes Receivable Farm Credit Banks and Other	141,383
Accounts Receivable - Other FC Banks	84,307
Accrued Interest Receivable - Other Farm Credit Banks	1,477
Accrued Interest Receivable - Investments	22,250
Acquired Property	757,980
Less: Allowance for Losses	83,322
Less: Accumulated Depreciation	0
Net Acquired Property	674,658
Land, Buildings, and Equipment	156,814
Less: Accumulated Depreciation	34,770
Net Land, Buildings, and Equipment	122,044
Prepaid Expenses and Other Assets	107,061
Total Assets	$ 53,279,980

Exhibit I-A.2
Federal Land Banks
Statement of Condition
Combined Totals
September 30, 1985
($ 000 Omitted)

Drafts Outstanding	$ 3,985
Notes Payable: FLBAs	475,764
Other Farm Credit Banks	0
Consolidated Systemwide Notes	1,238,242
Commercial Banks and Other	239,006
Securities Sold Under Agreement to Repurchase	125,434
Total Notes Payable	2,078,445
Accounts Payable	96,788
Accrued Interest Payable	1,460,566
Miscellaneous Trust Accounts	58,162
Unmatured Consolidated and Systemwide Bonds	44,293,745
Less: Consolidated Bonds Owned	222,000
Net Consolidated and System Bonds Outstanding	44,071,745
Unmatured Farm Credit Investment Bonds Outstanding	99,153
Matured Farm Credit Investment Bonds Outstanding	0
Other Liabilities	51,493
Total Liabilities	47,920,336
Capital Stock: Class B - FLBAs	2,522,786
Class C - FLBAs	0
Participation Certificates - FLBAs	148,355
Total Capital Stock	2,671,140
Earned Net Worth: Legal Reserve	1,681,369
Surplus Reserve	128,010
Earned Surplus	879,125
Total Earned Net Worth	2,688,504
Total Net Worth	5,359,644
Liabilities and Net Worth	$ 53,279,980

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Exhibit I-B.1
Federal Land Banks
Combined Statement of Income
September 30, 1985
($ 000 Omitted)

Loan Interest Income: Mortgage Loans	$ 1,371,372
Notes Receivable Other Farm Credit Banks	1,858
Sales Contracts (Net)	318
Penalty Other Interest Income	24,528
Total Interest Income from Loans	1,398,076
Income From Investments (Net)	37,870
Compensation Income - Participations Sold	0
Appraisal and Loan Service Fees	2,741
Financially Related Services	361
Other Operating Income	71
Gross Earnings	1,439,120
Notes and Bonds Expense: Cost of Bonds	1,297,227
Interest on Notes Payable	35,380
Interest on Future Payment Funds	6,493
Total Cost of Borrowed Funds	1,339,100
Compensation Expense - Participations Purchased	0
Operating Expense	66,113
Total Expenses	1,405,213
Net Gain (Loss) from Operations	33,906
Other Add/Deduct: Gain (Loss) - Sale of Investment	-15
Income (Expense) - Office Building or Premises	-50
Income (Expense) - Land/Buildings (Investment)	5
Income (Expense) - Acquired Property	-1,843
Gain (Loss) - Disposition of Acquired Property	1,091
Provision for Losses - Acquired Property	-75,525
Income (Expense) - Mineral Reservations	6,777
Interest on Investments - Buildings/Premises	212
Other Gains (Losses)	-15,353
Total Other Additions and Deductions	-84,705
Net Gain (Loss) Before Provision for Losses	-50,799
Provision for Losses on Loans	509,318
Net Earnings	$ -560,117

Exhibit I-C.1
Federal Land Banks
Statement of Condition
September 30, 1985
($ 000 Omitted)

	Springfield	Baltimore	Columbia	Louisville	Jackson	St. Louis
Loans: Unmatured Principal	$ 980,781	$ 2,142,437	$ 5,142,965	$ 3,746,603	$ 2,645,301	$ 4,483,337
Unmatured Extensions	0	0	6,375	0	33	1,931
Delinquent Principal and Advances	4,464	10,550	25,566	27,046	17,173	36,315
Loans in Process of Closing	808	2,106	155	1,672	3,320	275
Nonaccrual Loans	9,720	29,206	140,105	544,370	87,522	362,128
Accrued Interest Receivable on Loans	20,162	58,271	275,437	239,348	154,173	262,967
Gross Loan Items	1,015,935	2,242,565	5,590,606	4,559,039	2,907,521	5,146,953
Less: Allowance for Losses	14,735	20,035	53,464	48,323	72,493	82,456
Less: Deferred Proceeds of Loans	1,422	6,677	22,793	3,126	878	1,507
Less: Future Payment Funds	0	0	0	0	0	0
Less: Advance Payments	279	22,735	56,175	54,075	62,394	46,592
Less: Unamortized Loan Fees	0	0	0	0	1,506	0
Less: Unapplied Loan Payments	1,480	0	7,152	20,778	11,456	14,022
Net Loan Items	998,018	2,193,118	5,451,015	4,432,737	2,758,796	5,002,375
Cash	2,791	4,107	273	6,658	5,600	5,220
Investments: U.S. Government Securities (Par)	0	1,365	0	24,000	22,325	2,500
Securities Government Supervised Institutions (Par)	0	0	30,625	15,555	12,410	0
Other Securities and Federal Funds	66,000	153,751	80,153	83,787	45,971	249,257
Investment in UBC Bankers Acceptances (Par)	0	0	0	0	0	0
Unamortized Premium or Discount (Net)	0	-8	-37	-849	4	-79
Unamortized Defer Gain/Loss Security Sales (Net)	0	0	282	299	0	290
Total Investment in Securities	66,000	155,107	111,022	122,792	80,710	251,966
Notes Receivable Farm Credit Banks and Other	5,087	8,992	277	21,205	22,000	511
Accounts Receivable	2,228	1,154	70	47,273	208	250
Accrued Interest Receivable - Other Farm Credit Banks	35	57	19	74	135	0
Accrued Interest Receivable - Investments	138	3,512	1,010	984	1,297	960
Acquired Property	3,233	6,112	74,523	59,168	181,307	72,263
Less: Allowance for Losses	43	157	6,303	1,125	33,890	0
Less: Accumulated Depreciation	0	0	0	0	0	0
Net Acquired Property	3,190	5,955	68,220	58,043	147,417	72,263
Land, Buildings, and Equipment	16,036	12,875	7,340	10,048	10,538	11,220
Less: Accumulated Depreciation	4,057	2,617	3,350	4,572	1,425	2,467
Net Land, Buildings, and Equipment	11,979	10,257	3,989	5,476	9,113	8,753
Prepaid Expenses and Other Assets	2,234	4,561	9,469	15,654	6,140	6,565
Total Assets	$ 1,091,700	$ 2,386,821	$ 5,645,314	$ 4,710,896	$ 3,031,415	$ 5,348,862

Exhibit 1-C.2
Federal Land Banks
Statement of Condition
September 30, 1985
($ 000 Omitted)

	Springfield	Baltimore	Columbia	Louisville	Jackson	St. Louis
Drafts Outstanding	$ 12	$ -89	$ 249	$ 452	$ 303	$ 158
Notes Payable: FLBAs	14,782	57,965	40,974	49,315	3,145	19,104
Other Farm Credit Banks	0	0	0	0	0	0
Consolidated Systemwide Notes	67,398	73,789	0	0	23,875	193,218
Commercial Banks and Other	0	15,357	50,188	35,386	22,031	36,995
Securities Sold Under Agreement to Repurchase	0	0	0	4,875	0	0
Total Notes Payable	82,179	147,092	91,162	89,576	49,051	249,317
Accounts Payable	7,836	1,633	599	567	382	376
Accrued Interest Payable	27,137	57,348	162,749	136,561	85,921	146,062
Miscellaneous Trust Accounts	616	7,218	6,205	1,362	569	3,763
Unmatured Consolidated and Systemwide Bonds	849,925	1,802,100	4,721,388	4,177,791	2,649,800	4,419,500
Less: Consolidated Bonds Owned	0	0	47,000	100,000	25,000	0
Net Consolidated and System Bonds Outstanding	849,925	1,802,100	4,674,388	4,077,791	2,624,800	4,419,500
Unmatured Farm Credit Investment Bonds Outstanding	0	99,153	0	0	0	0
Matured Farm Credit Investment Bonds Outstanding	0	0	0	0	0	0
Other Liabilities	976	1,176	4,919	4,397	4,102	4,135
Total Liabilities	968,680	2,115,629	4,940,272	4,310,686	2,765,129	4,823,311
Capital Stock: Class B - FLBAs	53,768	104,538	249,331	235,719	135,451	263,845
Class C - FLBAs	0	0	0	0	0	0
Participation Certificates - FLBAs	6,269	14,100	39,429	9,049	13,691	5,369
Total Capital Stock	60,037	118,639	288,760	244,768	149,142	269,214
Earned Net Worth: Legal Reserve	62,191	76,686	216,915	134,697	77,803	160,885
Surplus Reserve	0	4,500	0	9,000	0	0
Earned Surplus	791	71,367	199,368	11,744	39,340	95,452
Total Earned Net Worth	62,982	152,553	416,283	155,442	117,143	256,337
Total Net Worth	123,020	271,192	705,063	400,209	266,286	525,551
Liabilities and Net Worth	$ 1,091,700	$ 2,386,821	$ 5,645,314	$ 4,710,896	$ 3,031,415	$ 5,348,862

Exhibit I-C.3
Federal Land Banks
Statement of Condition
September 30, 1985
($ 000 Omitted)

	St. Paul	Omaha	Wichita	Texas	Sacramento	Spokane
Loans: Unmatured Principal	$ 6,447,983	$ 4,806,231	$ 4,361,868	$ 2,747,111	$ 4,363,773	$ 3,472,305
Unmatured Extensions	9,011	2,108	0	11	0	0
Delinquent Principal and Advances	79,703	174,541	125,020	1,246	38,875	34,807
Loans in Process of Closing	0	0	1,639	9,668	2,451	0
Nonaccrual Loans *	714,647	591,496	479,477	6,666	191,232	140,739
Accrued Interest Receivable on Loans	335,452	380,793	266,548	142,689	263,366	234,203
Gross Loan Items	7,586,795	5,955,170	5,234,552	2,907,392	4,859,697	3,882,054
Less: Allowance for Losses	150,781	187,696	151,100	43,415	53,074	38,067
Less: Deferred Proceeds of Loans	9,800	3,682	1,117	9,374	33,587	1,758
Less: Future Payment Funds	0	76,214	116,949	68,059	35,676	75,315
Less: Advance Payments	80,328	97	11,463	12,224	9	0
Less: Unamortized Loan Fees	17,638	0	0	0	0	0
Less: Unapplied Loan Payments	-8,321	3,866	2,536	-1,582	1,058	1,367
Net Loan Items	7,336,570	5,683,615	4,951,307	2,775,903	4,736,296	3,765,567
Cash	8,593	8,500	1,787	3,692	965	6,209
Investments: U.S. Government Securities (Par)	25,400	13,000	50,000	5,750	17,000	0
Securities Government Supervised Institutions (Par)	18,819	5,000	10,000	0	41,726	15,000
Other Securities and Federal Funds	213,356	171,804	153,865	230,873	162,633	72,100
Investment in DBC Bankers Acceptances (Par)	0	0	0	0	0	0
Unamortized Premium or Discount (Net)	-3,262	-11	-1	-409	-1,985	-964
Unamortized Defer Gain/Loss Security Sales (Net)	0	0	0	0	0	0
Total Investment in Securities	254,312	189,792	213,863	236,013	219,372	86,136
Notes Receivable Farm Credit Banks and Other	17,569	6,630	13,499	0	33,587	12,025
Accounts Receivable	18,132	4,212	5,039	1,229	3,883	779
Accrued Interest Receivable - Other Farm Credit Banks	24	341	568	0	214	11
Accrued Interest Receivable - Investments	2,881	3,095	1,925	4,741	1,296	413
Acquired Property	101,195	84,034	72,616	3,331	67,987	32,212
Less: Allowance for Losses	7,337	21,604	4,441	0	4,781	3,641
Less: Accumulated Depreciation	0	0	0	0	0	0
Net Acquired Property	93,858	62,430	68,175	3,331	63,206	28,571
Land, Buildings, and Equipment	15,169	8,350	18,813	9,864	6,996	29,567
Less: Accumulated Depreciation	4,857	3,800	1,836	910	1,866	3,014
Net Land, Buildings, and Equipment	10,312	4,550	16,977	8,954	5,129	26,553
Prepaid Expenses and Other Assets	9,222	8,235	16,786	5,967	7,302	14,927
Total Assets	$ 7,751,472	$ 5,971,399	$ 5,290,006	$ 3,039,829	$ 5,071,249	$ 3,941,169

Exhibit I-C.4
Federal Land Banks
Statement of Condition
September 30, 1985
($ 000 Omitted)

	St. Paul	Omaha	Wichita	Texas	Sacramento	Spokane
Drafts Outstanding	$ 0	$ 0	$ 748	$ 0	$ 937	$ 1,216
Notes Payable: FLBAs	77,979	5,566	30,237	95,490	24,238	56,988
Other Farm Credit Banks	0	0	0	0	0	0
Consolidated Systemwide Notes	271,329	19,976	69,367	165,623	218,848	134,620
Commercial Banks and Other	52,027	425	0	0	273	26,323
Securities Sold Under Agreement to Repurchase	19,689	17,925	60,638	22,307	0	0
Total Notes Payable	421,025	43,891	160,442	283,420	243,359	217,931
Accounts Payable	92	47,823	37,301	163	25	141
Accrued Interest Payable	213,661	170,008	129,799	85,367	139,196	106,756
Miscellaneous Trust Accounts	26,367	9,041	2,863	1,390	-1,996	785
Unmatured Consolidated and Systemwide Bonds	6,203,400	5,290,000	4,423,793	2,361,350	4,206,700	3,187,998
Less: Consolidated Bonds Owned	0	50,000	0	0	0	0
Net Consolidated and System Bonds Outstanding	6,203,400	5,240,000	4,423,793	2,361,350	4,206,700	3,187,998
Unmatured Farm Credit Investment Bonds Outstanding	0	0	0	0	0	0
Matured Farm Credit Investment Bonds Outstanding	0	0	0	0	0	0
Other Liabilities	5,663	5,089	7,996	3,044	4,096	5,903
Total Liabilities	6,870,208	5,515,853	4,762,960	2,736,735	4,592,316	3,520,729
Capital Stock: Class B - FLBAs	359,623	286,483	242,668	141,795	258,948	190,619
Class C - FLBAs	0	0	0	0	0	0
Participation Certificates - FLBAs	20,936	8,037	12,597	11,005	2,039	5,832
Total Capital Stock	380,559	294,519	255,265	152,800	260,987	196,450
Earned Net Worth: Legal Reserve	291,562	161,027	197,191	74,846	113,050	114,516
Surplus Reserve	61,310	0	0	47,500	0	5,700
Earned Surplus	147,834	0	74,610	29,950	104,896	103,774
Total Earned Net Worth	500,706	161,027	271,801	152,296	217,946	223,990
Total Net Worth	881,265	455,546	527,066	305,093	478,933	420,440
Total Liabilities and Net Worth	$ 7,751,472	$ 5,971,399	$ 5,290,066	$ 3,039,829	$ 5,071,249	$ 3,941,169

Exhibit I-D.1
Federal Land Banks
Statement of Income
Three Months Ending September 30, 1985
($ 000 Omitted)

	Springfield	Baltimore	Columbia	Louisville	Jackson	St. Louis
Loan Interest Income: Mortgage Loans	$ 29,772	$ 61,976	$ 152,102	$ 106,432	$ 77,288	$ 131,850
Notes Receivable Other Farm Credit Banks	73	154	0	217	408	21
Sales Contracts (Net)	0	0	0	0	0	0
Penalty and Other Interest Income	496	666	1,230	291	2,008	412
Total Interest Income on Loans	30,342	62,796	153,332	106,940	79,704	132,283
Income from Investments (Net)	1,405	3,319	2,111	2,498	1,575	3,538
Compensation Income - Participations Sold	0	0	0	0	0	0
Appraisal and Loan Service Fees	0	1	772	0	275	261
Financially Related Services	0	10	0	57	73	11
Other Operating Income	28	20	0	0	0	0
Gross Earnings	31,774	66,146	156,215	107,496	81,627	136,093
Notes and Bonds Expense: Cost of Bonds	23,548	54,843	137,951	123,999	76,949	126,453
Interest on Notes Payable	1,874	2,553	2,351	1,633	1,172	42
Interest on Future Payment Funds	2	0	0	0	0	0
Total Cost of Borrowed Funds	25,424	57,396	140,302	125,632	78,122	126,495
Compensation Expense - Participations Purchased	0	0	0	0	0	0
Operating Expense	3,184	4,228	7,921	5,153	5,218	8,190
Total Expenses	28,608	61,624	148,223	130,785	83,340	134,685
Net Gain (Loss) from Operations	3,166	4,521	7,992	−23,289	−1,712	1,408
Other Add/Deduct: Gain (Loss) - Sale of Investment	0	−15	0	0	0	0
Income (Expense) Office Building and Premises	0	1	13	0	0	0
Income (Expense) Land/Buildings (Investment)	0	0	2	0	−7	0
Income (Expense) - Acquired Property	1	−32	−7	134	357	−60
Gain (Loss) - Disposition of Acquired Property	5	9	248	−615	118	26
Provision for Losses - Acquired Property	0	−47	−2,268	−9,028	−28,558	−11,230
Income (Expense) - Mineral Reservations	0	1	0	1	2,375	366
Interest on Investment - Buildings/Premises	25	128	59	0	0	0
Other Gains (Losses)	−974	−2,078	−5,278	−5,441	32,366	−4,979
Total Other Additions and Deductions	−964	−2,036	−7,233	−14,951	6,649	−15,879
Net Gain (Loss) before Provision for Losses	2,221	2,484	758	−38,240	4,937	−14,471
Provision for Losses	−260	−262	20,650	35,220	39,161	35,000
Net Earnings	$ 2,482	$ 2,747	$ −19,891	$ −73,461	$ −34,223	$ −49,471

Exhibit 1-D.2

Federal Land Banks
Statement of Income
Three Months Ending September 30, 1985

($ 000 Omitted)

	St. Paul	Omaha	Wichita	Texas	Sacramento	Spokane
Loan Interest Income: Mortgage Loans	$ 205,531	$ 166,598	$ 129,141	$ 78,016	$ 131,195	$ 103,472
Notes Receivable Other Farm Credit Banks	171	3	302	1	486	23
Sales Contracts (Net)	0	231	73	0	0	14
Penalty and Other Interest Income	3,646	3,929	7,899	86	1,153	2,711
Total Interest Income from Loans	209,347	170,762	137,416	78,102	132,832	106,220
Income from Investments (Net)	4,418	4,210	4,572	4,584	3,777	1,865
Compensation Income - Participations Sold	0	0	0	0	0	0
Appraisal and Loan Service Fees	404	16	0	42	964	6
Financially Related Services	32	178	0	0	0	0
Other Operating Income	3	16	3	0	1	0
Gross Earnings	214,204	175,181	141,991	82,728	137,574	108,091
Notes and Bonds Expense: Cost of Bonds	181,543	158,963	128,077	68,600	122,823	93,478
Interest on Notes Payable	7,296	1,226	4,491	5,308	3,734	3,700
Interest on Future Payment Funds	0	2,433	0	1,891	0	2,167
Total Cost of Borrowed Funds	188,839	162,622	132,568	75,798	126,557	99,345
Compensation Expense - Participations Purchases	0	0	0	0	0	0
Operating Expense	10,276	8,184	8,317	2,318	-1,617	4,742
Total Expenses	199,115	170,806	140,885	78,116	124,939	104,088
Net Gain (Loss) from Operations	15,090	4,375	1,106	4,612	12,634	4,003
Other Add/Deduct: Gain (Loss) - Sale of Investment	0	0	0	0	0	0
Income (Expense) Office Building and Premises	0	11	-2	0	0	-72
Income (Expense) Land/Buildings (Investment)	0	3	0	0	0	9
Income (Expense) - Acquired Property	3	-72	-1,191	-82	-284	-603
Gain (Loss) - Disposition of Acquired Property	0	-47	1,288	-25	-6	94
Provision for Losses - Acquired Property	-1,623	-18,778	-381	0	-3,118	-486
Income (Expense) - Mineral Reservations	1,306	38	1,511	782	63	336
Interest on Investment - Buildings/Premises	0	0	0	0	0	0
Other Gains (Losses)	-7,272	-6,157	-4,976	-2,567	-4,512	-3,476
Total Other Additions and Deductions	-7,587	-25,005	-3,753	-1,894	-7,859	-4,203
Net Gain (Loss) before Provision for Losses	7,502	-20,629	-2,647	2,717	4,775	-200
Provision for Losses	83,983	177,253	115,884	600	2,300	-209
Net Earnings	$ -76,480	$ -197,882	$ -118,531	$ 2,117	$ 2,475	$ 9

EXHIBIT 1-E.1
FEDERAL LAND BANKS
NONPERFORMING LOANS, CHARGEOFFS, AND FINANCIAL RATIOS
SEPTEMBER 30, 1985

	SPRINGFIELD	BALTIMORE	COLUMBIA	LOUISVILLE[1]	JACKSON	ST. LOUIS[1]
Nonperforming Loans ($ millions)	34.7	104.4	397.0	787.0	286.2	706.1
Formally Restructured	0	0.3	1.1	1.4	0.1	0
Other Restructured & Reduced Rate	0	0.3	0	0	0	0
Other High Risk	25.0	74.6	255.8	241.2	198.6	344.0
Nonaccrual	9.7	29.2	140.1	544.4	87.5	362.1
Net Loan Chargeoffs ($ millions)	a	0.9	4.7	22.0	8.4	30.0
Selected Ratios						
Return on Assets (%)	0.90	0.46	(1.40)	(6.04)	(4.45)	(3.68)
Return on Equity (%)	7.90	4.06	(11.08)	(65.98)	(47.64)	(35.65)
Net Interest Margin (%)	2.38	1.49	1.13	(1.69)	0.45	0.77
Capital to Assets	0.11	0.11	0.12	0.08	0.09	0.10
Debt to Capital	7.87	7.80	7.00	10.77	10.38	9.18

Components may not add to totals due to rounding.
* Indicates less than $50,000
a Indicates net recovery of less than $50,000
1 Indicates preliminary data, revisions expected

EXHIBIT 1-E.2
FEDERAL LAND BANKS
NONPERFORMING LOANS, CHARGEOFFS, AND FINANCIAL RATIOS
SEPTEMBER 30, 1985

	ST. PAUL	OMAHA	WICHITA[1]	TEXAS	SACRAMENTO	SPOKANE
Nonperforming Loans ($ millions)	1,052.3	860.2	867.4	55.5	521.5	426.0
Formally Restructured	*	1.5	2.5	3.4	0	0
Other Restructured & Reduced Rate	15.8	0.5	0	0.5	0	0
Other High Risk	321.9	266.7	385.4	44.9	330.3	285.3
Nonaccrual	714.6	591.5	479.5	6.7	191.2	140.7
Net Loan Chargeoffs ($ millions)	11.8	34.7	19.1	(0.3)	9.3	(0.3)
Selected Ratios						
Return on Assets (%)	(3.93)	(12.87)	(8.84)	0.28	0.20	0
Return on Equity (%)	(33.11)	(140.05)	(79.52)	2.79	2.06	0.01
Net Interest Margin (%)	1.42	0.90	0.78	0.93	0.86	0.97
Capital to Assets	0.11	0.08	0.10	0.10	0.09	0.11
Debt to Capital	7.80	12.11	9.04	8.96	9.59	8.37

Components may not add to totals due to rounding.
* Indicates less than $50,000
1 Indicates preliminary data, revisions expected

Exhibit 3-A.1

Federal Intermediate Credit Banks
Statement of Condition
Combined Totals
September 30, 1985
($000 Omitted)

Loans and Discounts: PCAs	$ 14,877,905
Other Financing Institutions	699,047
Participation Loans - PCAs	19,246
Other Participations	28,472
Sales Contracts, Notes, Etc.	3,857
Nonaccrual Loans	104,662
Accrued Interest Receivable on Loans	382,879
Gross Loan and Discount Items	16,116,067
Less: Allowance for Losses	51,077
Less: Unapplied Loan Payments	21,191
Net Loan and Discouunt Items	16,043,869
Cash	58,468
Investments: U.S. Government Securities (Par)	109,338
Securities Government Supervised Institutions (Par)	115,952
Other Securities and Federal Funds	1,455,703
Investment in DBC Bankers Acceptances (Par)	0
Unamortized Premium or Discount (Net)	-7,716
Unamortized Defer Gain/Loss Security Sales (Net)	1,288
Total Investment in Securities	1,674,564
Investments in PCAs: Paid in Surplus (Net)	600
Class A Stock	25,563
Class B Stock	0
Class D Stock	20,646
Total Investments in PCAs	46,808
Notes Receivable Farm Credit Banks and Other	78,388
Accounts Receivable	9,742
Accrued Interest Receivable - Other Farm Credit Banks	394
Accrued Interest Receivable - Investments	15,576
Acquired Property: Investments and Operations	15,491
Less: Allowance for Losses	2,296
Less: Accumulated Depreciation	2
Net Acquired Property	13,193
Land, Buildings, and Equipment	78,213
Less: Accumulated Depreciation	13,735
Net Land, Buildings, and Equipment	64,478
Prepaid Expenses and Other Assets	26,847
Total Assets	$ 18,032,328

Exhibit 3-A.2
Federal Intermediate Credit Banks
Statement of Condition
Combined Totals
September 30, 1985
($000 Omitted)

Notes Payable: Other Farm Credit Banks	$ 779
Consolidated Systemwide Notes	2,828,922
Commercial Banks and Other	108,771
Securities Sold Under Agreement to Repurchase	14,908
Total Notes Payable	2,953,380
Accounts Payable	126,712
Accrued Interest Payable	386,555
Unmatured Consolidated and Systemwide Bonds	12,628,405
Less: Consolidated Bonds Owned	88,199
Net Consolidated and System Bonds Outstanding	12,540,206
Unmatured Farm Credit Investment Bonds Outstanding	28,795
Matured Farm Credit Investment Bonds Outstanding	0
Other Liabilities	20,992
Total Liabilities	16,056,640
Capital Stock: Class B Stock - PCAs	1,343,810
Participation Certificates	68,839
Total Capital Stock	1,412,649
Earned Net Worth: Surplus Reserved	63,067
Surplus Unallocated	30,913
Legal Reserve	447,785
Reserve for Contingencies - Unallocated	33,197
Undistributed Earnings	-11,921
Total Earned Net Worth	563,039
Total Net Worth	1,975,688
Total Liabilities and Net Worth	$ 18,032,328

Exhibit 3-B.1

Federal Intermediate Credit Banks
Statement of Condition
Combined Totals
September 30, 1985
($000 Omitted)

Loan Interest Income: Loans and Discounts	$	422,901
Sales Contracts		96
Notes Receivable Other Farm Credit Banks		549
Other Interest Income		43
Total Interest Income from Loans		423,589
Income from Investments (Net)		28,806
Other Operating Income		76,376
Gross Earnings		528,772
Notes and Bonds Expense: Cost of Bonds		315,101
Interest on Notes Payable		48,997
Total Cost of Borrowed Funds		364,098
Compensation Expense - Participations Purchased		14
Operating Expense		25,720
Total Expenses		389,832
Net Gain (Loss) from Operations		138,940
Other Add/Deduct: Gain (Loss) - Sale of Investment		304
Income (Expense) - Office Building or Premises		11
Income (Expense) - Land/Buildings (Investment)		3
Income (Expense) - Acquired Property		-87
Gain (Loss) - Disposition of Acquired Property		28
Provision for Losses - Acquired Property		-449
Income (Expense) - Mineral Reservations		26
Other Gains (Losses)		-153,839
Total Other Additions and Deductions		-154,006
Net Gain (Loss) Before Provision for Losses		-15,066
Provision for Losses on Loans		24,425
Net Earnings	$	-39,491

Exhibit 3-C.1
Federal Intermediate Credit Banks
Statement of Condition
September 30, 1985
($000 Omitted)

	Springfield	Baltimore	Columbia	Louisville	Jackson	St. Louis
Loans and Discounts: FCAs	$ 602,683	$ 665,196	$ 1,505,039	$ 1,414,844	$ 580,804	$ 1,053,535
Other Financing Institutions	633	44,180	1,788	6,450	115,037	22,911
Participation Loans - FCAs	0	5,037	0	0	13,941	267
Other Participations	0	0	0	0	0	0
Sales Contracts, Notes, Etc.	0	0	0	0	0	0
Nonaccrual Loans	1,033	1,520	8,869	3,425	1,408	2,924
Accrued Interest Receivable on Loans	6	5,704	14,283	86,550	17,571	26,483
Gross Loan and Discount Items	604,354	721,636	1,529,979	1,509,269	728,762	1,106,119
Less: Allowance for Losses	0	766	5,966	11,881	3,527	3,359
Less: Unapplied Loan Payments	0	0	0	0	0	9,293
Net Loan and Discount Items	604,354	720,869	1,524,013	1,497,388	725,235	1,093,468
Cash	2,556	2,075	285	6,679	456	8,996
Investments: U.S. Government Securities (Par)	0	1,770	0	8,000	0	0
Securities Government Supervised Institutions (Par)	0	0	5,600	23,499	0	0
Other Securities and Federal Funds	64,000	139,257	100,716	51,664	25,479	133,767
Investment in DBC Bankers Acceptances (Par)	0	0	0	0	0	0
Unamortized Premium or Discount (Net)	0	-13	-52	-561	0	0
Unamortized Defer Gain/Loss Security Sales (Net)	0	0	271	253	0	0
Total Investment in Securities	64,000	141,013	106,535	82,833	25,479	133,767
Investments in FCAs: Paid in Surplus (Net)	0	0	0	0	0	600
Class A Stock	0	0	0	11,640	2,589	7,333
Class B Stock	0	0	0	0	0	0
Class D Stock	0	0	4,376	0	8,000	0
Total Investments in FCAs	0	0	4,376	11,640	10,589	7,933
Notes Receivable Farm Credit Banks and Other	5,183	11,018	0	20,000	23,601	0
Accounts Receivable	237	98	365	3,539	50	1,214
Accrued Interest Receivable - Other Farm Credit Banks	35	23	0	36	20	0
Accrued Interest Receivable - Investments	107	3,571	858	952	51	586
Acquired Property: Investments and Operations	0	0	306	0	51	546
Less: Allowance for Losses	0	0	45	0	0	0
Less: Accumulated Depreciation	0	0	0	0	0	0
Net Acquired Property	0	0	260	0	51	546
Land, Buildings, and Equipment	1,135	0	2,539	4,032	8,157	10,353
Less: Accumulated Depreciation	234	0	989	819	611	2,006
Net Land, Buildings, and Equipment	901	0	1,550	3,213	7,497	8,347
Prepaid Expenses and Other Assets	606	968	1,885	4,354	2,121	2,095
Total Assets	$ 677,979	$ 879,636	$ 1,640,108	$ 1,630,655	$ 795,150	$ 1,256,969

Exhibit 3-C.2
Federal Intermediate Credit Banks
Statement of Condition
September 30, 1985
($000 Omitted)

	Springfield	Baltimore	Columbia	Louisville	Jackson	St. Louis
Notes Payable: Other Farm Credit Banks	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Consolidated Systemwide Notes	117,072	95,625	30,976	39,847	102,593	152,000
Commercial Banks and Other	0	5,362	12,224	11,748	5,267	8,226
Securities Sold Under Agreement to Repurchase	0	0	0	4,875	0	0
Total Notes Payable	117,072	100,988	43,200	56,470	107,860	160,225
Accounts Payable	6,017	754	1,689	585	187	59
Accrued Interest Payable	14,334	17,840	37,556	37,810	14,926	25,871
Unmatured Consolidated and Systemwide Bonds	480,015	651,000	1,335,250	1,267,827	565,051	916,000
Less: Consolidated Bonds Owned	0	0	38,000	0	0	0
Net Consolidated and System Bonds Outstanding	480,015	651,000	1,297,250	1,267,827	565,051	916,000
Unmatured Farm Credit Investment Bonds Outstanding	0	28,783	0	0	0	0
Matured Farm Credit Investment Bonds Outstanding	0	0	0	0	0	0
Other Liabilities	39	216	1,173	251	114	1,306
Total Liabilities	617,477	799,580	1,380,868	1,362,963	688,138	1,103,461
Capital Stock: Class B Stock - PCAs	42,209	48,187	170,812	199,213	67,826	103,388
Participation Certificates	118	3,626	178	613	9,410	1,708
Total Capital Stock	42,327	51,813	170,991	199,826	77,236	105,096
Earned Net Worth: Surplus Reserved	4,593	4,177	3,701	5,273	4,105	4,819
Surplus Unallocated	367	431	2,092	3,153	1,332	2,880
Legal Reserve	13,214	17,031	70,252	57,205	20,950	34,855
Reserve for Contingencies - Unallocated	0	2,739	1,714	0	0	4,409
Undistributed Earnings	0	3,863	10,490	2,255	3,388	1,430
Total Earned Net Worth	18,175	28,242	88,249	67,886	29,776	48,393
Total Net Worth	60,502	80,555	259,240	267,713	107,012	153,488
Total Liabilities and Net Worth	$ 677,979	$ 879,636	$ 1,640,108	$ 1,630,655	$ 795,150	$ 1,256,949

Exhibit 3-C.3
Federal Intermediate Credit Banks
Statement of Condition
September 30, 1985
($000 Omitted)

	St. Paul	Omaha	Wichita	Texas	Sacramento	Spokane
Loans and Discounts: FCAs	$ 2,605,400	$ 1,367,830	$ 852,929	$ 915,789	$ 2,523,712	$ 790,146
Other Financing Institutions	90,039	77,533	82,150	180,934	73,955	3,438
Participation Loans - FCAs	0	0	0	0	0	0
Other Participations	0	0	0	0	0	28,472
Sales Contracts, Notes, Etc.	0	68	1,999	1,789	0	0
Nonaccrual Loans	7,337	27,507	2,258	3,859	33,799	10,723
Accrued Interest Receivable on Loans	76,110	42,675	8,306	8,902	88,871	9,418
Gross Loan and Discount Items	2,778,886	1,515,613	947,642	1,111,273	2,720,337	842,196
Less: Allowance for Losses	3,876	2,642	11,127	1,394	1,200	5,268
Less: Unapplied Loan Payments	9,871	410	0	1,617	0	0
Net Loan and Discount Items	2,765,139	1,512,561	936,514	1,108,262	2,719,137	836,928
Cash	11,968	1,918	3,257	2,137	14,095	4,065
Investments: U.S. Government Securities (Par)	65,000	6,300	10,000	3,268	10,000	5,000
Securities Government Supervised Institutions (Par)	34,537	1,000	18,500	0	11,000	21,817
Other Securities and Federal Funds	226,067	140,513	44,743	335,946	134,106	59,444
Investment in DBC Bankers Acceptances (Par)	0	0	0	0	0	0
Unamortized Premium or Discount (Net)	-4,286	35	279	-2,017	-55	-1,040
Unamortized Defer Gain/Loss Security Sales (Net)	422	107	0	236	0	0
Total Investment in Securities	321,739	147,955	73,522	337,431	155,050	85,220
Investments in FCAs: Paid in Surplus (Net)	0	0	0	0	0	0
Class A Stock	0	0	0	0	0	4,000
Class B Stock	0	0	0	0	0	0
Class D Stock	0	0	7,250	1,020	0	0
Total Investments in FCAs	0	0	7,250	1,020	0	4,000
Notes Receivable Farm Credit Banks and Other	6,732	987	21	0	846	10,000
Accounts Receivable	1,442	3,142	449	139	525	-576
Accrued Interest Receivable - Other Farm Credit Banks	0	176	61	0	8	34
Accrued Interest Receivable - Investments	2,378	1,615	1,237	1,427	2,215	581
Acquired Property: Investments and Operations	0	2,054	0	3,471	9,064	0
Less: Allowance for Losses	0	431	0	1,819	0	0
Less: Accumulated Depreciation	0	0	0	2	0	0
Net Acquired Property	0	1,622	0	1,650	9,064	0
Land, Buildings, and Equipment	13,132	3,353	17,896	9,726	6,167	1,223
Less: Accumulated Depreciation	3,856	1,083	1,337	637	1,854	259
Net Land, Buildings, and Equipment	9,276	2,770	16,559	9,089	4,313	964
Prepaid Expenses and Other Assets	3,678	1,686	1,455	3,031	3,177	1,793
Total Assets	$ 3,122,352	$ 1,674,431	$ 1,060,325	$ 1,464,186	$ 2,908,430	$ 942,988

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Exhibit 3-C.4
Federal Intermediate Credit Banks
Statement of Condition
September 30, 1985
($000 Omitted)

	St. Paul	Omaha	Wichita	Texas	Sacramento	Spokane
Notes Payable: Other Farm Credit Banks	$ 779	$ 0	$ 0	$ 0	$ 0	$ 0
Consolidated Systemwide Notes	531,911	267,661	99,737	451,347	748,572	191,582
Commercial Banks and Other	23,233	747	0	8,761	24,296	8,908
Securities Sold Under Agreement to Repurchase	0	7,255	0	2,778	0	0
Total Notes Payable	555,924	275,662	99,737	462,886	772,867	200,489
Accounts Payable	584	105,189	9,109	32	136	3,233
Accrued Interest Payable	73,150	35,934	24,523	25,531	59,158	19,922
Unmatured Consolidated and Systemwide Bonds	2,175,524	1,153,896	754,459	840,653	1,859,680	629,050
Less: Consolidated Bonds Owned	194	50,000	0	0	0	5
Net Consolidated and System Bonds Outstanding	2,175,330	1,103,896	754,459	840,653	1,859,680	629,045
Unmatured Farm Credit Investment Bonds Outstanding	12	0	0	0	0	0
Matured Farm Credit Investment Bonds Outstanding	0	0	0	0	0	0
Other Liabilities	12,023	346	715	2,888	553	1,368
Total Liabilities	2,817,022	1,521,028	888,543	1,331,990	2,692,392	854,058
Capital Stock: Class B Stock - PCAs	204,593	135,681	97,226	57,557	147,251	69,868
Participation Certificates	11,081	7,779	11,738	13,764	4,706	4,116
Total Capital Stock	215,675	143,460	108,964	71,321	151,957	73,984
Earned Net Worth: Surplus Reserved	7,049	6,069	5,257	7,593	4,541	5,890
Surplus Unallocated	1,818	1,244	1,507	14,007	1,260	821
Legal Reserve	70,275	48,538	36,055	23,636	49,906	5,868
Reserve for Contingencies - Unallocated	10,512	0	2,435	7,139	4,249	0
Undistributed Earnings	0	-45,906	-2,434	8,500	4,127	2,367
Total Earned Net Worth	89,655	9,943	42,819	60,875	64,081	14,946
Total Net Worth	305,329	153,403	151,782	132,196	216,038	88,930
Total Liabilities and Net Worth	$ 3,122,352	$ 1,674,431	$ 1,040,325	$ 1,464,186	$ 2,908,430	$ 942,988

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Exhibit 3-D.1

Federal Intermediate Credit Banks

Statement of Income

Three Months Ending September 30, 1985

($000 Omitted)

	Springfield	Baltimore	Columbia	Louisville	Jackson	St. Louis
Loan Interest Income: Loans and Discounts	$ 15,179	$ 17,575	$ 45,255	$ 35,408	$ 17,602	$ 26,499
Sales Contracts	0	0	0	0	0	0
Notes Receivable Other Farm Credit Banks	71	168	0	58	74	0
Other Interest Income	1	0	0	0	0	0
Total Interest Income from Loans	15,251	17,743	45,255	35,466	17,676	26,499
Income From Investments (Net)	1,240	2,859	1,814	1,603	211	1,722
Other Operating Income	155	4	0	0	0	0
Gross Earnings	16,645	20,605	47,069	37,069	17,887	28,221
Notes and Bonds Expense: Cost of Bonds	11,205	15,578	32,822	29,182	13,149	20,171
Interest on Notes Payable	2,219	1,728	1,104	601	1,333	3,029
Total Cost of Borrowed Funds	13,424	17,307	33,925	29,782	14,481	23,200
Compensation Expense - Participations Purchased	0	0	0	0	0	0
Operating Expense	1,391	1,434	1,627	2,214	1,404	2,489
Total Expenses	14,815	18,741	35,553	31,997	15,885	25,689
Net Gain (Loss) from Operations	1,830	1,864	11,517	5,072	2,002	2,532
Other Add/Deduct: Gain (Loss) - Sale of Investment	0	0	0	0	367	0
Income (Expense) - Office Building or Premises	20	0	0	0	-7	0
Income (Expense) - Land/Buildings (Investment)	0	0	0	0	0	0
Income (Expense) - Acquired Property	0	0	1	0	0	-1
Gain (Loss) - Disposition of Acquired Property	0	0	0	0	0	0
Provision for Losses - Acquired Property	0	0	-41	0	0	-35
Income (Expense) - Mineral Reservations	0	0	0	0	0	0
Other Gains (Losses)	-661	-743	-1,934	-2,928	-797	-2,503
Total Other Additions and Deductions	-641	-743	-1,975	-2,928	-438	-2,540
Net Gain (Loss) Before Provision for Losses	1,189	1,120	9,541	2,143	1,563	-8
Provision for Losses on Loans	0	249	2,762	4,814	302	0
Net Earnings	$ 1,189	$ 871	$ 6,778	$ -2,670	$ 1,261	$ -8

Exhibit 3-D.2
Federal Intermediate Credit Banks
Statement of Income
Three Months Ending September 30, 1985
($000 Omitted)

	St. Paul	Omaha	Wichita	Texas	Sacramento	Spokane
Loan Interest Income: Loans and Discounts	$ 76,234	$ 42,873	$ 25,898	$ 27,707	$ 69,086	$ 23,587
Sales Contracts	0	2	55	39	0	0
Notes Receivable Other Farm Credit Banks	64	1	0	0	38	74
Other Interest Income	0	17	0	0	26	0
Total Interest Income from Loans	76,298	42,892	25,953	27,746	69,149	23,661
Income From Investments (Net)	5,878	2,042	1,368	5,209	3,245	1,616
Other Operating Income	5	76,208	4	0	0	0
Gross Earnings	82,181	121,142	27,325	32,955	72,394	25,278
Notes and Bonds Expense: Cost of Bonds	58,763	28,899	19,000	20,981	48,535	16,817
Interest on Notes Payable	9,049	4,594	1,832	6,928	13,358	3,224
Total Cost of Borrowed Funds	67,811	33,493	20,832	27,909	61,893	20,040
Compensation Expense - Participations Purchased	0	0	0	0	0	14
Operating Expense	4,420	2,197	2,606	1,747	2,467	1,722
Total Expenses	72,232	35,690	23,438	29,656	64,360	21,777
Net Gain (Loss) from Operations	9,949	85,452	3,887	3,299	8,034	3,501
Other Add/Deduct: Gain (Loss) - Sale of Investments	-62	0	0	0	0	0
Income (Expense) - Office Building or Premises	0	0	0	0	0	0
Income (Expense) - Land/Buildings (Investment)	0	3	0	0	0	0
Income (Expense) - Acquired Property	0	-7	0	-12	-65	0
Gain (Loss) - Disposition of Acquired Property	0	0	0	28	0	0
Provision for Losses - Acquired Property	0	-383	0	11	0	0
Income (Expense) - Mineral Reservations	0	0	0	26	0	0
Other Gains (Losses)	-17,748	-120,978	-1,246	-1,465	-2,824	-1
Total Other Additions and Deductions	-17,811	-121,368	-1,246	-1,413	-2,890	-1
Net Gain (Loss) Before Provision for Losses	-7,862	-35,915	2,639	1,886	5,143	3,499
Provision for Losses on Loans	1,459	1,992	10,692	55	600	1,5000
Net Earnings	$ -9,321	$ -37,907	$ -8,052	$ 1,831	$ 4,543	$ 1,999

EXHIBIT 3-E.1

FEDERAL INTERMEDIATE CREDIT BANKS
NONPERFORMING LOANS, CHARGEOFFS, AND FINANCIAL RATIOS
SEPTEMBER 30, 1985

	SPRINGFIELD	BALTIMORE	COLUMBIA	LOUISVILLE	JACKSON	ST. LOUIS
Nonperforming Loans ($ millions)	1.0	106.2	503.7	4.3	15.3	130.8
Formally Restructured	0	0	40.0	0.9	0	0
Other Restructured & Reduced Rate	0	0	0	0	0	0
Other High Risk	0	104.7	454.8	0	13.9	127.9
Nonaccrual	1.0	1.5	8.9	3.4	1.4	2.9
Net Loan Chargeoffs ($ millions)	0	0	0.9	0	#	#
Selected Ratios						
Return on Assets (%)	0.71	0.40	1.58	(0.66)	0.68	0
Return on Equity (%)	7.68	4.38	10.60	(3.97)	4.73	(0.2)
Net Interest Margin (%)	1.83	1.55	3.11	1.93	1.92	1.74
Capital-to-Assets	0.09	0.09	0.16	0.16	0.13	0.12
Debt-to-Capital	10.21	9.99	5.33	5.09	6.43	7.19

Less than $50,000 net recovery.

EXHIBIT 3-E.2

FEDERAL INTERMEDIATE CREDIT BANKS
NONPERFORMING LOANS, CHARGEOFFS, AND FINANCIAL RATIOS
SEPTEMBER 30, 1985

	ST. PAUL	OMAHA	WICHITA	TEXAS	SACRAMENTO	SPOKANE
Nonperforming Loans ($ millions)	767.6	1,201.0	251.5	94.3	502.5	405.4
Formally Restructured	234.1	0	27.3	0	310.3	0
Other Restructured & Reduced Rate	0	0	0	0	0	0
Other High Risk	526.2	1,173.5	221.9	90.4	158.4	394.7
Nonaccrual	7.3	27.5	2.3	3.9	33.8	10.7
Net Loan Chargeoffs ($ millions)	0	0.4	0	#	0	0
Selected Ratios						
Return on Assets (%)	(1.18)	(8.83)	(2.99)	0.51	0.63	0.79
Return on Equity (%)	(11.99)	(87.88)	(20.46)	5.55	8.50	9.09
Net Interest Margin (%)	1.88	2.86	2.49	1.44	1.53	2.23
Capital-to-Assets	0.10	0.09	0.15	0.09	0.07	0.09
Debt-to-Capital	9.23	9.92	5.85	10.08	12.46	9.60

Less than $50,000 net recovery

Exhibit 5-A.1

Banks for Cooperatives
Combined Statement of Condition
September 30, 1985
($000 Omitted)

Loans to Cooperatives: Seasonal Loans	$2,739,731
Term	4,554,347
Commodity	153,295
Acceptances	89,823
Subtotal	7,537,197
Less: Participations	0
Less: Acceptances Discounted to Other FC Banks	0
Less: Unapplied Loan Payments	6,956
Less: Unearned Income (Acceptances)	1,109
Total Loans to Cooperative Associations	7,529,132
Nonaccrual Loans	130,477
Sales Contracts, Notes, Etc.	91,441
Accrued Interest Receivable on Loans	153,548
Gross Loan Items	7,904,598
Less: Allowance for Losses	122,383
Net Loan Items	7,782,215
Cash	19,904
Investments: U.S. Government Securities (Par)	6,800
Securities Government Supervised Institutions (Par)	41,954
Other Securities and Federal Funds	1,454,841
Unamortized Premium or Discount (Net)	-3,629
Total Investment in Securities	1,499,965
Investments in Central Bank for Cooperatives	0
Investments in Other Banks for Cooperatives	0
Investments in DBC Bankers Acceptances (Net)	0
Notes Receivable Farm Credit Banks and Other	33,860
Accounts Receivable	11,816
Accrued Interest Receivable - Other Farm Credit Banks	1,001
Accrued Interest Receviable - Investments	7,900
Acquired Property	6,678
Less: Accumulated Depreciation	87
Less: Allowance for Losses	263
Net Acquired Property	6,328
Land, Buildings, and Equipment	52,838
Less: Accumulated Depreciation	9,140
Net Land, Buildings, and Equipment	43,699
Customers Liability on Acceptances Outstanding	0
Prepaid Expenses and other Assets	28,635
Total Assets	$9,435,322

Exhibit 5-A.2

Banks for Cooperatives
Combined Statement of Condition
September 30, 1985
($000 Omitted)

Notes Payable: Other Farm Credit Banks	$ 219,360
Consolidated Systemwide Notes	3,435,846
Commercial banks and Other	24,470
Securities Sold Under Agreement to Repurchase	25,068
Total Notes Payable	3,704,745
Accounts Payable	22,004
Accrued Interest Payable	127,738
Unmatured Consolidated and Systemwide Bonds	4,248,881
Less: Consolidated Bonds Owned	35,000
Net Consolidated and System Bonds Outstanding	4,213,881
Unmatured Farm Credit Investment Bonds Outstanding	148,123
Matured Farm Credit Investment Bonds Outstanding	0
Capital Stock and Equities Called For Retirement	1,775
Bankers Liability on Acceptances Outstanding	0
Other Liabilities	9,559
Total Liabilities	8,227,825
Capital Stock: Class B - All	475
Class C - District Banks	0
Class C - Cooperative Associations	792,763
Class D - All	1,127
Other - Cooperative Associations	1,530
Class C - Subscribed - Cooperative Associations	36,484
Class C - Subscribed - District Banks	0
Total Capital Stock	832,378
Earned Net Worth: Surplus Reserved	88,111
Surplus Allocated to Cooperative Associations	198,810
Surplus Allocated to District Banks	0
Surplus Unallocated	38,710
Undistributed Earnings	49,488
Total Earned Net Worth	375,119
Total Net Worth	1,207,497
Total Liabilities and Net Worth	$9,435,322

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Exhibit 5-B.1
Banks for Cooperatives
Combined Statement of Income
September 30, 1985
($000 Omitted)

Loan Interest Income: Cooperative Associations	$196,928
Sales Contracts	2,281
Notes Receivable Other Farm Credit Banks	373
Other Interest Income	890
Total Interest Income from Loans	200,472
Income from Investments (Net)	31,934
Compensation Income - Participations Sold	0
Appraisal and Loan Service Fees	3
Financially Related Services	25
Customers Draft Accepted Fees	0
Letters of Credit Issued Fees	975
Income from Distribution of Earnings of Central BC	0
Income from Dist. of Earnings of Other District Banks	0
Gross Earnings	233,408
Notes and Bonds Expense: Cost of Bonds	123,197
Interest on Notes Payable	71,174
Total Cost of Borrowed Funds	194,371
Compensation Expense - Participations Purchased	0
Operating Expense	16,417
Total Expenses	210,788
Net Gain (Loss) from Operations	22,620
Other Add/Deduct: Gain (Loss) - Sale of Investment	-126
Income (Expense) Acquired Property	10
Gain (Loss) - Disposition of Acquired Property	1
Provision for Losses - Acquired Property	0
Income (Expense) Office Building or Premises	102
Income (Expense) Land/Buildings (Investment)	-2
Other Gains (Losses)	-9,744
Other Income (Expense)	61
Total Other Additions and Deductions	-9,701
Net Gain (Loss) Before Provision for Losses	12,919
Provision for Losses	-5,240
Net Earnings before Income Taxes	7,677
Less: Federal and Other Income Taxes	548
Net Earnings	$7,129

Exhibit 5-C.1
Banks for Cooperatives
Statement of Condition
September 30, 1985
($000 Omitted)

	Springfield	Baltimore	Columbia	Louisville	Jackson	St. Louis
Loans to Cooperatives: Seasonal Loans	$120,729	$91,617	$ 39,739	$142,811	$159,258	$162,446
Term	259,643	97,472	399,037	521,227	755,867	277,215
Commodity	0	0	46,449	0	0	24,425
Acceptances	0	0	0	0	4,500	0
Subtotal	380,372	189,089	485,226	664,038	919,604	464,086
Less: Participations	229,308	124,025	249,203	239,516	620,135	101,743
Less: Acceptances Discounted to Other FC Banks	0	0	0	0	0	0
Less: Unapplied Loan Payments	0	0	0	384	3,561	0
Less: Unearned Income (Acceptances)	0	0	0	0	32	0
Total Loans to Cooperative Associations	151,064	65,064	236,022	424,138	295,876	362,344
Nonaccrual Loans	629	1,648	18,082	1,239	2,359	2,206
Sales Contracts, Notes, Etc.	39	87	13,612	0	0	2,860
Accrued Interest Receivable on Loans	3,751	-1,046	-1,487	-1,210	6,636	7,549
Gross Loan Items	155,484	65,751	266,228	424,166	304,872	374,959
Less: Allowance for Losses	2,022	1,900	4,938	7,711	4,837	10,137
Net Loan Items	153,461	63,851	261,290	416,456	300,035	364,821
Cash	223	-149	279	1,146	4,993	1,974
Investments: U.S. Government Securities (Par)	0	0	0	0	1,000	0
Securities Government Supervised Institutions (Par)	0	0	0	10,000	3,000	4,000
Other Securities and Federal Funds	14,000	19,893	14,400	53,799	22,404	61,966
Unamortized Premium or Discount (Net)	0	0	0	89	-16	-22
Total Investment in Securities	14,000	19,893	14,400	63,888	26,388	65,942
Investments in Central Bank for Cooperatives	19,870	8,313	24,208	24,837	43,746	16,999
Investments in Other Banks for Cooperatives	244	0	578	0	0	0
Investments in DBC Bankers Acceptances (Net)	0	0	0	0	0	0
Notes Receivable Farm Credit Banks and Other	2,895	5,116	675	9	30,000	5,957
Accounts Receivable	4,406	1,072	319	245	899	1,861
Accrued Interest Receivable - Other Farm Credit Banks	11	28	4	1	355	0
Accrued Interest Receviable - Investments	36	543	56	983	418	452
Acquired Property	0	0	0	0	0	86
Less: Accumulated Depreciation	0	0	0	0	0	0
Less: Allowance for Losses	0	0	0	0	0	0
Net Acquired Property	0	0	0	0	0	86
Land, Buildings, and Equipment	1,135	0	430	3,122	6,969	5,215
Less: Accumulated Depreciation	234	0	253	902	576	889
Net Land, Buildings, and Equipment	901	0	177	2,220	6,394	4,326
Customers Liability on Acceptances Outstanding	0	0	0	0	0	0
Prepaid Expenses and other Assets	282	522	5,498	2,033	1,043	1,020
Total Assets	$196,330	$99,189	$307,483	$511,818	$415,072	$463,440

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Exhibit 5-C.2
Banks for Cooperatives
Statement of Condition
September 30, 1985
($000 Omitted)

	Springfield	Baltimore	Columbia	Louisville	Jackson	St. Louis
Notes Payable: Other Farm Credit Banks	$ 0	$ 0	$ 4,078	$ 4,000	$ 7,555	$ 0
Consolidated Systemwide Notes	49,755	19,858	64,718	27,745	82,069	41,578
Commercial banks and Other	0	571	0	0	2,165	3,339
Securities Sold Under Agreement to Repurchase	0	0	0	10,200	0	0
Total Notes Payable	49,755	20,429	68,796	41,965	91,789	44,917
Accounts Payable	2,737	318	3,600	3,643	387	1,326
Accrued Interest Payable	2,533	1,451	4,829	10,180	5,586	8,168
Unmatured Consolidated and Systemwide Bonds	88,010	53,962	175,480	321,850	169,000	307,000
Less: Consolidated Bonds Owned	0	0	10,000	0	0	0
Net Consolidated and System Bonds Outstanding	88,010	53,962	165,480	321,850	169,000	307,000
Unmatured Farm Credit Investment Bonds Outstanding	0	3,233	2,120	32,751	25,640	6,050
Matured Farm Credit Investment Bonds Outstanding	0	0	0	0	0	0
Capital Stock and Equities Called For Retirement	0	0	0	0	0	0
Bankers Liability on Acceptances Outstanding	0	0	0	0	0	0
Other Liabilities	196	45	588	343	234	47
Total Liabilities	143,230	79,438	245,413	410,712	292,635	367,510
Capital Stock: Class B - All	0	0	0	0	0	0
Class C - District Banks	0	239	95	52	179	624
Class C - Cooperative Associations	34,964	13,327	39,560	68,041	94,758	62,611
Class D - All	0	0	0	0	0	0
Other - Cooperative Associations	0	0	0	0	0	0
Class C - Subscribed - Cooperative Associations	3,132	0	3,772	255	204	3,211
Class C - Subscribed - District Banks	0	0	0	0	0	56
Total Capital Stock	38,096	13,566	43,426	68,348	95,141	66,503
Earned Net Worth: Surplus Reserved	4,419	2,576	4,371	5,100	3,628	6,154
Surplus Allocated to Cooperative Associations	9,090	190	8,779	22,586	19,694	16,746
Surplus Allocated to District Banks	0	5	18	21	49	175
Surplus Unallocated	646	2,756	3,964	691	1,912	2,731
Undistributed Earnings	851	659	1,512	4,282	2,013	3,621
Total Earned Net Worth	15,006	6,185	18,644	32,759	27,295	29,428
Total Net Worth	53,100	19,751	62,070	101,107	122,437	95,930
Total Liabilities and Net Worth	$196,330	$99,189	$307,483	$511,818	$415,072	$463,440

Exhibit 5-C.3
Banks for Cooperatives
Statement of Condition
September 30, 1985
($000 Omitted)

	St. Paul	Omaha	Wichita	Texas	Sacramento	Spokane	Central
Loans to Cooperatives: Seasonal Loans	$ 299,911	$128,714	$152,966	$ 31,208	$589,382	$219,812	$1,411,340
Term	1,116,787	313,113	322,612	123,162	182,997	202,422	1,813,601
Commodity	17,686	3,000	54,700	3,100	12,281	0	9,978
Acceptances	32,000	0	4,433	2,000	0	0	71,323
Subtotal	1,466,384	444,827	534,711	159,470	784,659	422,234	3,306,243
Less: Participations	485,104	29,826	108,414	20,703	311,400	105,160	59,210
Less: Acceptances Discounted to Other FC Banks	0	0	0	0	0	0	0
Less: Unapplied Loan Payments	0	1,156	1,644	0	211	0	0
Less: Unearned Income (Acceptances)	146	23	114	0	0	0	794
Total Loans to Cooperative Associations	981,134	413,822	424,539	138,767	473,049	317,074	3,246,239
Nonaccrual Loans	4,261	5,777	1,580	5,393	32,457	1,960	52,885
Sales Contracts, Notes, Etc.	10,035	159	174	382	34,973	369	28,750
Accrued Interest Receivable on Loans	27,891	12,669	10,903	3,948	7,553	7,286	69,108
Gross Loan Items	1,023,321	432,428	437,196	148,490	548,033	326,689	3,396,982
Less: Allowance for Losses	18,708	5,538	4,724	2,266	15,589	5,004	39,007
Net Loan Items	1,004,613	426,890	432,472	146,224	532,443	321,685	3,357,975
Cash	5,070	1,122	2,415	1,013	1,045	397	376
Investments: U.S. Government Securities (Par)	0	5,000	0	0	0	800	0
Securities Government Supervised Institutions (Par)	0	11,000	0	0	450	13,500	4
Other Securities and Federal Funds	130,147	69,938	51,701	81,088	4,174	33,956	897,375
Unamortized Premium or Discount (Net)	-1,157	-12	-172	-184	0	-632	-1,516
Total Investment in Securities	128,989	85,925	51,528	80,903	4,624	47,623	895,862
Investments in Central Bank for Cooperatives	69,140	5,350	21,455	5,058	21,194	10,706	0
Investments in Other Banks for Cooperatives	2,683	0	7,861	316	0	0	0
Investments in DBC Bankers Acceptances (Net)	0	0	0	0	0	0	0
Notes Receivable Farm Credit Banks and Other	28,295	10,856	1,999	586	34,729	3,249	13,559
Accounts Receivable	5,243	926	2,902	383	4,549	978	670
Accrued Interest Receivable - Other Farm Credit Banks	790	104	39	19	56	9	243
Accrued Interest Receivable - Investments	1,227	1,632	45	352	34	80	2,042
Acquired Property	647	542	734	2,359	683	372	1,254
Less: Accumulated Depreciation	0	0	0	0	0	87	0
Less: Allowance for Losses	0	166	0	0	0	97	0
Net Acquired Property	647	376	734	2,359	683	188	1,254
Land, Buildings, and Equipment	6,046	2,612	2,021	10,006	4,826	8,443	2,015
Less: Accumulated Depreciation	1,418	1,003	531	432	1,046	851	1,006
Net Land, Buildings, and Equipment	4,627	1,609	1,490	9,573	3,779	7,592	1,009
Customers Liability on Acceptances Outstanding	0	0	0	0	0	0	0
Prepaid Expenses and other Assets	6,850	1,445	1,426	812	640	1,416	6,722
Total Assets	$1,258,175	$536,234	$526,364	$247,997	$603,776	$393,922	$4,279,714

Exhibit 5-C.4
Banks for Cooperatives
Statement of Condition
September 30, 1985
($000 Omitted)

	St. Paul	Omaha	Wichita	Texas	Sacramento	Spokane	Central
Notes Payable: Other Farm Credit Banks	$ 8,913	$ 0	$ 11,500	$ 0	$ 0	0	$ 287,379
Consolidated Systemwide Notes	175,394	976	111,627	65,564	277,110	149,602	2,369,852
Commercial Banks and Other	8,710	0	0	1,236	4,204	2,448	1,798
Securities Sold Under Agreement to Repurchase	0	14,868	0	0	0	0	0
Total Notes Payable	193,016	15,844	123,127	66,798	281,314	152,050	2,659,029
Accounts Payable	4,027	6,581	3,999	27	1,485	409	7,951
Accrued Interest Payable	27,047	13,517	5,918	3,435	4,550	6,447	34,738
Unmatured Consolidated and Systemwide Bonds	788,610	412,250	215,114	97,001	190,000	177,000	1,253,605
Less: Consolidated Bonds Owned	0	25,000	0	0	0	0	0
Net Consolidated and System Bonds Outstanding	788,610	387,250	215,114	97,001	190,000	177,000	1,253,605
Unmatured Farm Credit Investment Bonds Outstanding	7,175	11,605	25,398	32,521	0	1,630	0
Matured Farm Credit Investment Bonds Outstanding	0	0	0	0	0	0	0
Capital Stock and Equities Called For Retirement	0	0	0	5	0	1,769	0
Bankers Liability on Acceptances Outstanding	0	0	0	0	0	0	0
Other Liabilities	2,347	1,349	841	309	597	171	2,494
Total Liabilities	1,022,222	436,145	374,396	200,096	477,946	339,476	3,957,817
Capital Stock: Class B - All	0	0	0	0	475	0	0
Class C - District Banks	1,117	6,361	230	389	0	554	229,515
Class C - Cooperative Associations	158,621	69,032	101,861	26,492	85,056	38,440	0
Class D - All	1,127	0	0	0	0	0	0
Other - Cooperative Associations	0	0	1,530	0	0	0	0
Class C - Subscribed - Cooperative Associations	11,677	2,768	4,230	381	5,510	1,342	0
Class C - Subscribed - District Banks	37	189	0	11	0	0	0
Total Capital Stock	172,578	78,350	107,851	27,274	91,040	40,336	229,515
Earned Net Worth: Surplus Reserved	6,638	2,423	6,336	5,038	6,658	5,014	29.676
Surplus Allocated to Cooperative Associations	50,743	13,891	23,584	4,515	21,235	7,859	0
Surplus Allocated to District Banks	322	746	48	71	0	117	32,210
Surplus Unallocated	5,670	3,717	4,511	9,852	1,359	1,375	8,681
Undistributed Earnings	0	962	7,637	853	5,538	-254	21,815
Total Earned Net Worth	63,374	21,739	42,116	20,228	34,789	14,109	92,382
Total Net Worth	235,953	100,089	149,967	47,502	125,830	54,445	321,897
Total Liabilities and Net Worth	$1,258,175	$536,234	$524,366	$247,597	$603,776	$393,922	$4,279,714

Exhibit 5-D.1
Banks for Cooperatives
Statement of Income
Three Months Ending September 30, 1985
($000 Omitted)

	Springfield	Baltimore	Columbia	Louisville	Jackson	St. Louis
Loan Interest Income: Cooperative Associations	$3,809	$1,539	$6,385	$11,842	$7,776	$9,960
Sales Contracts	1	68	416	0	0	0
Notes Receivable Other Farm Credit Banks	43	65	6	11	227	0
Other Interest Income	0	0	0	0	357	65
Total Interest Income from Loans	3,854	1,673	6,807	11,853	8,360	10,025
Income from Investments (Net)	317	409	589	1,518	751	1,236
Compensation Income - Participations Sold	2	0	0	0	0	0
Appraisal and Loan Service Fees	0	0	0	0	0	3
Financially Relate Services	0	0	0	0	0	12
Customers Draft Accepted Fees	0	0	0	0	0	0
Letters of Credit Issued Fees	46	0	36	1	126	0
Income from Distribution of Earnings of Central BC	2,215	366	0	0	0	258
Income from Dist. of Earnings of Other District Banks	0	0	0	0	0	0
Gross Earnings	6,433	2,448	7,433	13,372	9,237	11,534
Notes and Bonds Expense: Cost of Bonds	2,338	1,389	4,846	9,429	5,838	8,490
Interest on Notes Payable	780	374	1,604	1,002	1,286	351
Total Cost of Borrowed Funds	3,119	1,763	6,449	10,431	7,124	8,841
Compensation Expense - Participations Purchased	0	2	0	0	0	0
Operating Expense	480	334	717	1,375	1,140	941
Total Expenses	3,599	2,098	7,166	11,805	8,263	9,782
Net Gain (Loss) from Operations	2,834	350	266	1,567	974	1,752
Other Add/Deduct: Gain (Loss) - Sale of Investment	0	0	0	-126	0	0
Income (Expense) Acquired Property	0	0	0	0	0	0
Gain (Loss) - Disposition of Acquired Property	0	0	0	0	0	0
Provision for Losses - Acquired Property	0	0	0	0	0	0
Income (Expense) Office Building or Premises	0	0	0	0	0	0
Income (Expense) Land/Buildings (Investment)	0	0	0	0	-7	0
Other Gains (Losses)	-403	-185	-39	-1,180	-925	-583
Other Income (Expense)	21	0	15	3	0	0
Total Other Additions and Deductions	-381	-185	-24	-1,304	-933	-583
Net Gain (Loss) Before Provision for Losses	2,452	163	242	262	39	1,168
Provision for Losses	0	-249	-239	-149	-249	-149
Net Earnings before Income Taxes	2,452	-86	2	112	-210	1,018
Less: Federal and Other Income Taxes	0	-3	75	0	0	91
Net Earnings	$2,452	$ -82	$ -72	$ 112	$ -210	$ 927

Exhibit 5-D.2
Banks for Cooperatives
Statement of Income
Three Months Ending September 30, 1985
($000 Omitted)

	St. Paul	Omaha	Wichita	Texas	Sacramento	Spokane	Central
Loan Interest Income: Cooperative Associations	$27,736	$12,693	$10,811	$4,147	$12,946	$8,440	$78,846
Sales Contracts	189	5	0	13	841	10	737
Notes Receivable Other Farm Credit Banks	404	107	71	1	81	39	489
Other Interest Income	787	3	55	-12	0	0	7
Total Interest Income from Loans	29,116	12,808	10,937	4,147	13,868	8,489	80,079
Income from Investments (Net)	2,457	1,958	799	1,650	78	898	19,273
Compensation Income - Participations Sold	0	0	0	0	0	0	0
Appraisal and Loan Service Fees	0	0	0	0	0	0	0
Financially Related Services	0	0	12	0	0	0	0
Customers Draft Accepted Fees	0	0	0	0	0	0	0
Letters of Credit Issued Fees	64	12	8	19	1	1	659
Income from Distribution of Earnings of Central BC	2,364	401	337	213	800	255	0
Income from Dist. of Earnings of Other District Banks	0	0	0	0	0	0	0
Gross Earnings	34,001	15,179	12,093	6,029	14,748	9,644	100,011
Notes and Bonds Expense: Cost of Bonds	21,962	11,444	6,331	3,368	5,294	5,782	36,687
Interest on Notes Payable	3,634	412	1,725	1,226	5,950	2,154	52,217
Total Cost of Borrowed Funds	25,595	11,857	8,056	4,594	11,244	7,936	86,903
Compensation Expense - Participations Purchased	0	0	0	0	0	0	0
Operating Expense	2,051	1,411	1,811	867	875	885	3,531
Total Expenses	27,646	13,268	9,867	5,461	12,119	8,821	92,434
Net Gain (Loss) from Operations	6,355	1,911	2,227	568	2,628	823	7,577
Other Add/Deduct: Gain (Loss) - Sale of Investment	0	0	0	0	0	0	0
Income (Expense) Acquired Property	-14	-1	0	-4	0	32	0
Gain (Loss) - Disposition of Acquired Property	0	0	0	0	0	0	0
Provision for Losses - Acquired Property	0	0	0	0	0	0	0
Income (Expense) Office Building or Premises	0	0	0	0	0	-27	130
Income (Expense) Land/Buildings (Investment)	0	2	0	0	0	3	0
Other Gains (Losses)	-1,797	-1,792	-665	-263	-1,154	-472	-275
Other Income (Expense)	11	-4	3	5	1	0	7
Total Other Additions and Deductions	-1,800	-1,797	-663	-263	-1,154	-464	-138
Net Gain (Loss) Before Provision for Losses	4,553	113	1,563	303	1,473	358	7,438
Provision for Losses	-299	-2,154	-194	-224	-1,149	-176	0
Net Earnings before Income TAXES	4,253	-2,041	1,368	78	323	182	7,438
Less: Federal and Other Income Taxes	189	74	0	0	0	25	99
Net Earnings	$ 4,064	$-2,115	$ 1,369	$ 78	$ 323	$ 157	$ 7,339

EXHIBIT 5-E.1

BANKS FOR COOPERATIVES
NONPERFORMING LOANS, CHARGEOFFS, AND FINANCIAL RATIOS
SEPTEMBER 30, 1985

	SPRINGFIELD	BALTIMORE	COLUMBIA	LOUISVILLE	JACKSON	ST. LOUIS
Nonperforming Loans ($ millions)	0.6	5.3	60.5	2.6	2.9	34.7
Formally Restructured	0	0.1	0	0	0	0
Other Restructured & Reduced Rate	0	0	0	0	0	0
Other High Risk	a	3.6	42.5	1.4	0.5	32.5
Nonaccrual	0.6	1.6	18.0	1.2	2.4	2.2
Net Chargeoffs ($ millions)	0	0	2.0	0	0.1	(0.5)
Selected Ratios						
Return on Assets (%)	5.05	(0.33)	(0.09)	0.8	(0.20)	0.77
Return on Equity (%)	18.63	(1.60)	(0.47)	0.42	(0.69)	3.84
Net Interest Margin (%)	2.51	1.40	1.27	2.27	2.21	2.13
Capital-to-Assets	0.27	0.20	0.20	0.20	0.29	0.21
Debt-to-Capital	2.70	4.02	3.95	4.06	2.39	3.83

a Indicates less than $50,000
* Indicates net loan chargeoff less than $50,000

Exhibit 6-A.1
TRENDS IN CONDITION AND INCOME

Federal Land Banks
Summary of Condition

	12-31-84	03-31-85	06-30-85	09-30-85	12-31-85
Loans - total principal	52,261.5	52,103.9	51,056.4	49,254.9	
Performing	48,276.7	46,769.4	45,614.3	43,156.5	
Restructured	6.2	8.1	8.3	10.3	
Other restructured & reduced rate	9.0	42.8	9.8	17.1	
Other high risk	2,853.8	3,980.5	3,570.1	2,773.7	
Nonaccrual	1,115.8	1,303.1	1,853.9	3,297.3	
Less: Allowance for losses	547.1	529.2	512.7	915.6	
Net loans	51,714.4	51,574.7	50,543.7	48,339.3	
Cash & investments in securities	1,260.3	1,316.9	1,388.3	2,041.4	
Net acquired property	313.8	400.2	568.9	674.7	
Other assets net of adjustments	2,159.8	1,327.9	1,709.8	2,224.6	
Total assets	55,448.3	54,619.7	54,210.7	53,280.0	
Total liabilities	49,411.1	48,525.7	48,182.2	47,920.3	
Capital stock & participation certificates	2,854.1	2,841.1	2,772.8	2,671.1	
Earned net worth	3,183.0	3,252.9	3,255.7	2,688.5	
Total net worth	6,037.1	6,094.0	6,026.5	5,359.6	

Components may not add to exact totals due to rounding.

Exhibit 6-A.2
Federal Land Banks
Trends in Income and Expenses

	9 months ending					
	09-30-84	09 -30-85	03-31-85	06-30-85	09-30-85	12-31-85
Total Interest Income	4,671.2	4,509.5	1,546.7	1,526.8	1,435.9	—
Less: Total Interest Expense	4,323.0	4,096.4	1,392.9	1,364.4	1,339.1	—
Net Interest Income	348.2	413.1	153.8	162.4	96.8	—
Less: Provision for Loan Losses	20.1	612.0	22.8	79.9	509.8	—
Net Interest Income after Provision	328.1	(198.9)	131.0	82.5	(412.5)	—
Plus: Other Income	50.7	13.5	8.2	4.5	3.2	—
Less: Other Expenses	189.0	301.9	69.3	84.2	150.8	—
Net Income	169.8	(487.3)	69.9	2.8	(560.1)	—

Exhibit 6-A.3
Federal Land Banks
Trends in Selected Financial Measures

	12-31-84	03-31-85	06-30-85	09-30-85	12-31-85
Return on assets (%)	0.34	0.51	0.02	(4.17)	—
Return on equity (%)	3.08	4.61	0.19	(39.35)	—
Net interest margin (%)	0.89	1.18	1.26	0.75	—
Net chargeoffs on loans ($ millions)	90.4	40.7	98.3	140.3	—
Capital-to-assets ratio	0.11	0.11	0.11	0.10	—
Debt-to-capital ratio	8.18	7.96	7.99	8.94	—

Source: Reports of financial condition and performance.
Components may not sum to totals due to rounding.

Exhibit 6-B.1
Federal Intermediate Credit Banks
Summary of Condition

	12-31-84	03-31-85	06-30-85	09-30-85	12-31-85
Loans - total principal	17,274.3	16,012.0	16,202.5	15,733.2	
Performing	14,827.3	13,215.7	12,373.4	11,749.6	
Restructured	31.1	35.1	38.5	612.5	
Other restructured & reduced rate	—	260.5	299.5	0	
Other high risk	2,135.0	2,253.9	3,362.3	3,266.4	
Nonaccrual	280.9	246.8	128.8	104.7	
Less: Allowance for losses	29.3	32.1	34.2	51.0	
Net loans	17,245.0	15,979.9	16,168.3	15,682.2	
Cash & investments in securities	1,328.1	1,254.4	1,296.9	1,733.0	
Net acquired property	3.5	3.0	4.6	13.2	
Other assets net of adjustments	784.6	687.1	691.3	603.9	
Total assets	19,361.2	17,924.4	18,161.1	18,032.3	
Total liabilities	17,362.6	15,894.3	16,144.7	16,056.6	
Capital stock & participation certificates	1,425.4	1,424.4	1,416.5	1,412.6	
Earned net worth	573.2	605.6	599.9	563.0	
Total net worth	1,998.6	2,030.0	2,016.4	1,975.7	

Components may not add to exact totals due to rounding.

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Exhibit 6-B.2
Federal Intermediate Credit Banks
Trends in of Income and Expenses

	9 months ending 09-30-84	9 months ending 09-30-85	03-31-85	06-30-85	09-30-85	12-31-85
Total Interest Income	1,603.9	1,382.1	481.0	448.7	452.4	—
Less: Total Interest Expense	1,410.5	1,164.7	420.7	379.9	364.1	—
Net Interest Income	193.4	217.4	60.3	68.8	88.3	—
Less: Provision for Loan Losses	2.0	51.4	4.1	22.9	24.4	—
Net Interest Income after Provision	191.4	166.0	56.2	45.9	63.9	—
Plus: Other Income	0.5	76.6	0.6	(0.1)	76.4	
Less: Other Expenses	67.9	242.0	24.0	38.6	179.7	—
Net Income	124.0	0.6	32.8	7.2	(39.4)	—

Exhibit 6-B.3
Federal Intermediate Credit Banks
Trends in Selected Financial Measures

	12-31-84	03-31-85	06-30-85	09-30-85	12-31-85
Return on assets (%)	0.62	0.70	0.02	(0.87)	—
Return on equity (%)	6.17	6.52	0.19	(7.89)	—
Net interest margin (%)	1.38	1.37	1.26	2.03	—
Net chargeoffs on loans ($ millions)	21.9	1.2	98.3	1.3	—
Capital-to-assets ratio	0.10	0.11	0.11	0.11	—
Debt-to-capital ratio	8.69	7.83	7.99	8.13	—

Exhibit 6-C.1
Banks for Cooperatives
Summary of Condition

	12-31-84	03-31-85	06-30-85	09-30-85	12-31-85
Loans - total principal	9,014.0	9,168.1	8,343.2	7,751.1	
Performing	8,476.2	8,553.1	7,793.2	7,199.0	
Restructured	44.8	36.0	39.6	14.4	
Other restructured & reduced rate	0.3	0.2	0.0	47.6	
Other high risk	478.1	564.9	480.2	359.6	
Nonaccrual	14.6	13.9	30.2	130.5	
Less: Allowance for losses	121.2	124.6	128.2	122.4	
Net loans	8,892.8	9,043.5	8,215.0	7,628.7	
Cash & investments in securities	843.5	908.1	1,516.0	1,519.9	
Net acquired property	3.9	3.9	6.3	6.3	
Other assets net of adjustments	334.3	309.0	332.7	280.4	
Total assets	10,074.5	10,264.5	10,069.5	9,435.3	
Total liabilities	8,867.9	9,061.0	8,850.2	8,227.8	
Capital stock & participation certificates	861.3	835.4	843.5	832.4	
Earned net worth	345.3	368.1	375.9	375.1	
Total net worth	1,206.6	1,203.5	1,219.4	1,207.5	

Components may not add to exact totals due to rounding.

Exhibit 6-C.2
Banks for Cooperatives
Trends in of Income and Expenses

	9 months ending					
	09-30-84	09-30-85	03-31-85	06-30-85	09-30-85	12-31-85
Total Interest Income	892.8	759.2	266.7	260.1	232.4	—
Less: Total Interest Expense	740.9	628.4	220.3	213.7	194.4	—
Net Interest Income	151.9	130.8	46.4	46.4	38.0	—
Less: Provision for Loan Losses	11.3	12.5	3.4	3.8	5.2	—
Net Interest Income after Provision	140.6	118.3	43.0	42.6	32.8	—
Plus: Other Income	3.4	2.9	0.9	1.0	1.0	—
Less: Other Expenses	44.8	60.3	16.0	17.7	26.5	—
Net Income	99.0	60.9	27.9	25.9	7.1	—

Exhibit 6-C.3
Banks for Cooperatives
Trends in Selected Financial Measures

	12-31-84	03-31-85	06-30-85	09-30-85	12-31-85
Return on assets (%)	1.29	1.10	1.02	0.29	—
Return on equity (%)	11.09	9.25	8.55	2.35	—
Net interest margin (%)	1.99	1.85	1.84	1.58	—
Net chargeoffs on loans ($ millions)	10.1	*	0.2	11.1	—
Capital-to-assets ratio	0.12	0.12	0.12	0.13	—
Debt-to-capital ratio	7.35	7.53	7.26	6.81	—

Source: Reports of financial condition and performance.
Components may not sum to totals due to rounding.

* Indicates less than $50,000.

Appendix B

Percentage distribution of commercial farm operators and their assets and debt, by financial position

January 1985

Financial position	Operators	Assets	Total debt	Debt owed to--		
				Banks	Farm Credit System	Farmers Home Adm.
Good.........	70	65	51	47	53	39
Fair.........	13	18	16	15	15	18
Stressed.....	7	7	10	13	12	12
Vulnerable...	10	10	23	25	20	31
Total.....	100	100	100	100	100	100

Data for 634,000 "commercial" farms with sales of $40,000 or more in 1984, from the 1984 Farm Costs and Returns Survey, ERS, USDA. Dr. Emanuel Melichar, Farm Economist, Federal Reserve, October 23, 1985, testimony before the subcommittee on economic stailization of the House Banking, Financial, and Urban Affairs Committee, page 11.

Chairman LaFalce. Our next witness will be Mr. Bud Gerhart of the IBAA.

Mr. Gerhart, again we will put the entire text of your statement in the record, and I would ask that you try to make your presentation within no more than a 10-minute period.

We are anxious to begin the questioning period by the members of the panel.

Thank you.

STATEMENT OF BUD GERHART, CHAIRMAN, AGRICULTURE/RURAL AMERICA COMMITTEE, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, AND PRESIDENT, FIRST NATIONAL BANK, NEWMAN GROVE, NE

Mr. Gerhart. I think I can do that, Mr. Chairman.

I am Bud Gerhart, chairman, Agricultural/Rural America Committee of the Independent Bankers Association of America, and president of the First National Bank of Newman Grove, NE.

All our loans in that part of the State are agricultural loans.

I live in a town of about 950 people totally dependent on agriculture.

The IBAA is a national trade association representing about 7,500 local community banks, at least half of which are devoting a lot of lending to farmers, ranchers, and other agriculture products.

The commercial banks are the largest suppliers of operating credit to farmers with $40 billion of production credit more than all other non-Federal sources combined.

This production financing is vital for debt service purposes since farmers can't service real estate debts which are supplied mostly by the Farm Credit System unless they also have adequate operating credit.

Farm loan losses are up substantially. In 1984, net charge-offs of farm production loans at commercial banks were 2.2 percent of total farm loans outstanding. For the first two quarters of 1985, net charge-offs are running almost double that rate.

In mid-1985, the Federal Reserve estimates that about $3.6 billion—9 percent—of the $40 billion of production credit owed by farmers to commercial banks was delinquent.

An additional amount of debt held by commercial banks is severely stressed. With agricultural prices off 20 to 25 percent virtually across the board, compared to a year ago, and with a mounting backlog of nonperforming loans, it will be even more difficult for agricultural banks to finance farmers in 1986.

To deal with the problems of farm debt and financing, the IBA emphasized two basic considerations.

First, establishing the highest possible level of farm commodity prices and income supports in the farm bill in a multiyear basis is the most critical step in preventing more farmers from sliding into insolvency.

If we don't get these guys back on an economic base that they can pay their bills with, everything else we do is not going to work.

We have recommended that, at a mimimum, the farm income supports—target prices—must be maintained at existing levels for the next 4 years.

Even this won't prevent the continued deterioration of the farm economy.

Farmers must have adequate income to service debt. A farm program that improves prices and income will benefit farmers as well as lenders and may, in the long run, be much less costly than massive Federal assistance to lenders.

To achieve this, we believe that farmers should have the right to decide whether they want to use mandatory production controls combined with higher price support loan levels during this period of depressed prices and overproduction.

We can't sell this stuff. We have to limit production.

Second, as various options are considered, it is very important to know that all lenders and their borrowers are treated equitably and accorded an equal opportunity to work their way out of their present difficulties.

The Farm Credit System has now drafted a bill to Congress which would provide massive Federal assistance on a unilateral basis to the farm credit banks.

Among other provisions, first, their draft legislation would provide for a $5 or $6 billion direct financial Federal assistance to farm credit banks.

Second, provide for deferring of repayments in these Federal funds for an indefinite time based on regulations of the FCA.

Third, provide for zero interest rates to be paid on these Federal funds during any year such as this year, in which the Farm Credit System does not have positive earnings.

Fourth, to provide for Federal tax-exempt status for all securities issued by the FCA through its central entity located in Denver, CO, during the period prior to repayment of the Federal assistance.

The draft legislation would give directly to this central entity the farm credit, a vast array of corporate operating powers, and separate draft legislation. The FCA has recommended to Congress that they be given regulatory and supervisory powers so they may receive as an independent, arm's length regulator of the Farm Credit System.

We are working with the House Committee on Agriculture regarding legislative proposals which that committee has under consideration at this time.

It is impossible to predict what form the bill will take which they may approve. We believe that any legislation that is approved will have serious implications for matters within the Banking Committee's jurisdiction, and we have joined with ABA in strongly urging the committee to seek an appropriate referral of any such legislation to this committee.

A copy of our joint letter to Chairman St Germain is attached to my testimony.

In response, the IBAA has taken the following position.

First, we would support legislation changing the Farm Credit Administration into an independent arm's length regulator of the Farm Credit System.

The FCA should be reformed so that it actually functions as a true regulator—the Farm Credit Administration should be reformed so it functions as a true regulator similar to the way the banking regulators function with regard to commercial banks.

Second, we have no problem with—and would encourage—the pooled use of the Farm Credit System's own capital resources on a systemwide basis.

New legislation may not be necessary for that purpose since the FCA has implemented procedures for systemwide capital pooling based on a 1981 statute.

If legislation is deemed necessary, it should be strictly limited to clarifying the authority of the Farm Credit Administration to achieve full pooling of the Systems' capital.

The legislation should not provide statutory authority directly to any central Farm Credit System entity.

The FCA can delegate any administrative functions necessary for pooling purposes.

Based upon the latest available figures, the Farm Credit System has a stronger capital position than the average capital level of the approximately 5,000 commercial agricultural banks.

In the October 30 hearings before the House Agriculture Committee, the Farm Credit System spokesman stated that the System's capital totaled $13.1 billion, which would be about 17.7 percent of the $74 billion of assets.

The latest Federal Reserve data show that comparable capital for commercial agriculture banks averaged 9.5 percent of assets.

Even without the borrowers' stock, the Farm Credit System's capital composed of net worth and reserves total $7.1 billion, 9.6 percent of the System's assets.

The critical figures, we feel, are 17.7 percent capital as opposed to 9.5 percent capital in the agricultural banking systems.

Third, any Federal financial assistance extended must be accessible on a fully equitable basis to commercial agricultural banks and their farm borrowers.

We oppose unilateral Federal assistance to the credit banks. If that is recommended to the Congress by the Farm Credit System, it must be administered by an entity such as a subsidiary of the Farmers' Home Administration, outside of the Farm Credit System, and therefore could be impartially accessible to commercial agricultural banks and farm credit banks.

Agricultural banks are often in direct competition with lending. We would consider it unfair for commercial agricultural banks to be permitted to continue to fail in record numbers since the 1930's, and at the same time relieve the cooperative Farm Credit System of its loan losses through a direct and unilateral infusion of money from the Federal Treasury.

Furthermore, such an approach would not solve the problem of individual farmers in getting affordable operating credit for production purposes.

We would instead prefer putting any available Federal funds into high price and income supports in the farm bill pending development of a farm debt restructuring plan equitable to all farm lenders and borrowers.

In the meantime, Chairman Volcker has testified before the House Banking Committee earlier this year that he is prepared to make available the Federal Reserve's discount window to the Farm Credit System, if that became necessary for liquidity purposes.

Other steps can be taken to relieve some financial stress in the Agricultural Committee.

Some measures are being taken. Each of these measures in the farm bill, Farmers Home Administration guaranteed loans and others, are equally available to farm credit banks and borrowers and commercial agricultural banks and their borrowers.

In summary, we continue to believe the price and income supports in the general farm bill are the best way to assist financially stressed farmers, thus indirectly benefiting lenders.

Keeping yet another tier of our good farmers from slipping into insolvency should be our primary goal.

With regard to any Federal assistance directed to farm debt problems, we cannot emphasize too strongly the need for equitable treatment of agricultural banks and their farm borrowers in order to keep operating credit flowing in agricultural banks in a competitive and viable position.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you very much, Mr. Gerhart.

[The prepared statement of Mr. Gerhart follows:]

TESTIMONY

of

Bud Gerhart
President
The First National Bank

Newman Grove, Nebraska

and

Chairman, Agriculture-Rural Committee

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

on

Agricultural Credit Problems

Before the
Committee on Banking, Finance and Urban Affairs
Subcommittee on Economic Stabilization
Honorable John J. LaFalce, Chairman

Washington, D.C.
2167 Rayburn House Office Bldg.

November 14, 1985
9:30 a.m.

Mr. Chairman and members of the Subcommittee, I am Bud Gerhart, Chairman of the Agriculture-Rural Committee of the Independent Bankers Association of America and President of the First National Bank, Newman Grove, Nebraska.

The IBAA is a national trade association representing about 7,500 local community banks, almost half of which are substantially committed to lending to crop farmers, ranchers, and other agricultural producers. Hundreds of those agricultural banks have 75 percent or more of their total loans devoted to farm production.

The commercial banks are the largest suppliers of operating credit to farmers, with about $40 billion of production credit, more than all other non-Federal sources combined. This production financing is vital for debt servicing purposes, since farmers cannot service real-estate debt, supplied mostly by the Farm Credit System, without adequate operating credit.

Farm loan losses are up substantially. In 1984, net charge-offs of farm production loans at commercial banks were 2.2 percent of total farm loans outstanding. For the first two quarters of 1985, net charge-offs are running almost double that rate. At mid-1985, the Federal Reserve estimates that $3.6 billion (9 percent) of the $40 billion of production credit owed by farmers to commercial banks was delinquent. An additional amount of agricultural debt held by commercial banks is severely stressed.

With agricultural prices off 20-25 percent virtually across the board compared to a year ago, agricultural banks will find it more difficult to finance many farm borrowers. With the mounting backlog of nonperforming loans, it will be even more difficult to finance farmers in 1986.

To deal with the problems of farm debt and financing, the IBAA has emphasized two basic considerations:

First, establishing the highest possible level of farm commodity price and income supports in the farm bill on a multi-year basis is the most critical step in preventing more farmers from sliding into insolvency. We have recommended that, at a minimum, the farm income supports (target prices) must be maintained at existing levels for the next four years. Even this will not prevent the continued deterioration of the farm economy. Farmers must have adequate income to service debt. A farm program that improves prices and farm income will benefit farmers as well as lenders and may be less costly than massive Federal assistance to lenders. To achieve this, we believe that farmers should have the right to decide whether they want to use mandatory production controls combined with higher price support loan levels during this period of depressed prices and overproduction.

Second, as various options are considered for coping with the farm debt problem, it is very important that all lenders and their farm borrowers are treated equitably and accorded an equal opportunity to work their way out of the present difficulties.

The Farm Credit System has now drafted and has recommended to Congress legislation which would provide massive Federal assistance on a unilateral basis to Farm Credit banks. Among other provisions, their draft legislation would (1) provide for $6 billion of direct Federal financial assistance to Farm Credit banks, (2) provide for deferral of repayments on these Federal funds for an indefinite time based upon regulations of the Farm Credit Administration; (3) provide for zero interest rates to be paid on these Federal funds during any year (such as 1985) in which the Farm Credit System did not have positive earnings; and (4) provide for a Federal tax-exempt status for all securities issued by the Farm Credit System through its central entity located in Denver, Colorado during the period prior to repayment of the Federal assistance. The draft legislation would give directly to this central entity (the Farm Credit Capital Corporation) a vast array of corporate operating powers. In separate draft legislation, the Farm

Credit Administration has recommended to Congress that FCA be given regulatory and supervisory powers so that the FCA might serve as an independent, "arm's length" regulator of the Farm Credit System.

We are working with the House Committee on Agriculture regarding legislative proposals which that Committee has under consideration at this time, although it is impossible to predict what form a bill would take which they may approve. We believe that any legislation that is approved will have serious implications for matters within the Banking Committee's jurisdiction, and we have joined with the ABA in strongly urging this Committee to seek an appropriate referral of any such legislation to this Committee. A copy of our joint letter to Chairman St Germain is attached.

In response, the IBAA has taken the following position:

First, we would support legislation changing the Farm Credit Administration into an independent, arm's length regulator of the Farm Credit System. The FCS should be reformed so that it actually functions as a true regulator of Farm Credit banks, similar to the way that the banking regulators function with regard to commercial banks.

Second, we have no problem with--and would encourage--the pooled use of the Farm Credit System's own capital resources on a system-wide basis. New legislation may not be necessary for that purpose, since the FCA has implemented procedures for System-wide capital pooling based upon a 1981 statute. If legislation is deemed necessary, it should be strictly limited to clarifying the authority of the Farm Credit Administration to achieve full pooling of the System's capital. The legislation should not provide statutory authority directly to any central Farm Credit System entity. The FCA can delegate any administrative functions necessary for pooling purposes.

Based upon the latest available figures, the Farm Credit System has a stronger capital position than the average capital level of the approximately 5,000 commercial agricultural banks. In October 30 hearings before the House Agriculture Committee, the Farm Credit System spokesman stated that the System's capital totalled $13.1 billion, or 17.7 percent of the $74 billion of assets. Latest Federal Reserve data show that comparable capital for commercial agricultural banks averages 9.5 percent of assets. Even without the borrowers' stock, the Farm Credit System's capital (composed of earned net worth and reserves for losses) totalled $7.1 billion, or 9.6 percent of the System's assets.

Third, any Federal financial assistance extended to the Farm Credit System must be accessible, on a fully equitable basis, to commercial agricultural banks and their farm borrowers. We oppose unilateral Federal assistance to the Farm Credit banks. If Federal assistance such as recommended to Congress by the Farm Credit System were to be seriously considered, it must be administered by an entity such as a subsidiary to the Farmers Home Administration which is outside of the Farm Credit System, and therefore could be impartially accessible to commercial agricultural banks and Farm Credit banks.

Commercial agricultural banks often are in direct competition with the lending entities of the Farm Credit System. We would consider it patently unfair for commercial agricultural banks to be permitted to continue to fail in record numbers (since the 1930s), and at the same time relieve the cooperative Farm Credit System of its loan losses through a direct and unilateral infusion of money from the Federal Treasury. Furthermore, such an approach would not solve the problem of individual farmers in getting affordable operating credit for production purposes. We would instead prefer putting any available Federal funds into higher price and income supports in the farm bill, pending the development of farm debt restructuring plans which are equitable to all farm lenders and their farm borrowers.

In the meantime, Federal Reserve Board Chairman Paul Volcker has testified before the House Banking Committee earlier this year that he is prepared to make available the Federal Reserve's discount window to the Farm Credit System, if that became necessary for liquidity purposes.

Other steps can be taken to relieve some of the financial stress in the agricultural economy. Some measures are being taken. Each of those measures--price and income supports in the general farm bill, Farmers Home Administration guaranteed loans, and others--are equally available to Farm Credit banks and their borrowers, and to commercial agricultural banks and their borrowers.

In summary, we continue to believe that the price and income supports in the general farm bill are the best way to assist financially-stressed farmers thus indirectly benefitting lenders. Keeping yet another tier of our good farmers from slipping into insolvency should be our primary goal. With regard to any Federal assistance directed to farm debt problems, we cannot emphasize too strongly the need for the equitable treatment of agricultural banks and their farm borrowers--in order to keep operating credit flowing and agricultural banks in a fully competitive and viable position.

This concludes my prepared statement, Mr. Chairman, and I would be pleased to respond to any questions.

November 13, 1985

Hon. Fernand J. St Germain,
Chairman
House Committee on Banking, Finance
and Urban Affairs
2129 Rayburn House Office Bldg.
Washington, D.C. 20515

Dear Mr. Chairman:

The House Agriculture Subcommittee on Conservation, Credit, and Rural Development is now considering proposals that would provide federal assistance to the Farm Credit System (FCS) and make significant changes in the System's regulation and operation. It is impossible to determine the final form a proposal may take, but we are confident that the Agriculture Committee will make a serious effort to act this year. Though the Administration has not yet agreed to support financial assistance, it has not closed the door. In any event, the Administration has agreed in principle to important changes in the FCS.

We believe that, based on what we now know, any proposal that emerges from the Agriculture Committee will have profound implications for matters within your Committee's jurisdiction, and we urge you to seek a commitment that such legislation will be referred to the Banking Committee.

There are a number of reasons why we believe the Banking Committee's interests are at stake in this matter:

- Most of the proposals now on the table involve some form of direct loan or line of credit from the Treasury to private entities, i.e. the units of the FCS. Under House Rule X, clause 1(d)(7), the Banking Committee has jurisdiction over "financial aid to commerce and industry..." We need not detail for you similar assistance programs that have been considered by the Banking Committee in recent years, except to cite the Lockheed, New York City, and Chrysler Corporation bills that Congress adopted after Banking Committee action.

- Federal Reserve Board Chairman Paul Volcker testified before your Committee earlier this year that he was prepared to open the Fed's discount window to the Farm Credit System if that became necessary. Any legislation designed to assist the FCS should be examined by the Banking Committee in light of this pledge by Chairman Volcker.

Hon. Fernand J. St Germain
November 13, 1985
Page 2

- The Farm Credit System has long been an important, direct competitor to the thousands of commercial banks that make agricultural loans. Both the FCS and these commercial banks are severely affected by the current crisis in rural America. Yet, the proposals being actively considered by the Agriculture Committee completely ignore the problems of commercial banks and their farmer and rancher borrowers. We believe it is vital to the commercial banking industry and rural communities that any FCS assistance and reform proposal take into account the competitive positions of the FCS and its commercial bank competitors.

- One purpose of any assistance for the Farm Credit System would be to enable them to continue to sell their securities in the nation's bond markets. The sale of securities by other federally-related entities whose activities affect the housing market, such as the Federal National Mortgage Association (FNMA) and the Federal National Mortgage Corporation (FNMC), could be affected if FCS securities gain a greater federal backing than these housing-oriented agencies now enjoy.

As you can see, Mr. Chairman, the implications of Farm Credit System assistance legislation extend far beyond the concerns of the Agriculture Committee, affecting matters of direct concern to you and the Members of your Committee. We strongly urge you to seek an appropriate referral of any such legislation if it is reported by the Agriculture Committee.

Sincerely,

B.F. Backlund
President
Independent Bankers
Association of America

Donald T. Senterfitt
President
American Bankers Association

Copy to all members of the House Committee on Banking, Finance and Urban Affairs

Chairman LaFalce. The next witness will be the representative of the American Bankers Association, Mr. Taylor.

STATEMENT OF TIMOTHY TAYLOR, CHAIRMAN, GOVERNMENT RELATIONS AGRICULTURAL TASK FORCE, AMERICAN BANKERS ASSOCIATION, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, FIRST OF AMERICA BANK-HOLLAND, HOLLAND, MI

Mr. Taylor. Thank you, Mr. Chairman.

I am Timothy Taylor, president of First America Bank in Holland, MI, and I am representing the ABA as chairman of the ABA Government Relations Agricultural Task Force.

I want to thank the committee for its interest in these agricultural credit issues. They are really of very great importance to the whole of banking in this country.

I am here to discuss the deteriorating agricultural situation and the current status of the Farm Credit System and proposals for its assistance.

Let me assure the committee that ABA does recognize the severity of the problems facing Farm Credit System.

We emphasize this because agricultural bankers face the same problems, declining farm income and asset devaluation.

That results in intensified farm credit problems.

In this context, farmers, agricultural suppliers and creditors must be given time to adjust to the current environment of deflation of assets, high interest rates, and the overpriced dollar.

We are here today to discuss the focus on credit and the Farm Credit System. ABA supports the survival of the Farm Credit System, and recognizes that Federal assistance may be necessary. We urge the committee to review the agricultural credit situation and the Farm Credit System's proposals for assistance from two perspectives.

First, survival of the System is a short-term problem for both the System and agricultural banks.

Second, any congressional response to the short-term goal has long-term implications for the role of the Farm Credit System in relation to farm commercial banks and the structure of agricultural financing in the future.

ABA has testified numerous times to object to an ever-broadened mandate for this cooperative financial institution.

We have expressed our concern about a lax regulatory agency, the Farm Credit Administration specifically, that was not independent.

The Farm Credit System has made a major study of its future, its structure, and the role of agricultural finance, titled Project 1995.

Congress is faced with a very difficult situation. The System is requesting a major assistance package and implying that if assistance is not approved, total collapse will result.

From one perspective, this is the worst time to raise the question of what the role of the Farm Credit System should be.

From another perspective, it is precisely the time in which this question must be asked.

There are internal changes going on within the Farm Credit System that are remaking the system structure, changing the locus of the decisionmaking, and increasing the range of services offered in competition with agricultural banks.

There is a game plan outlined in Project 1995 for these changes. If Congress does not consider the role that it wishes the Farm Credit System to play in agricultural lending as it develops an assistance package, it will be confirming by default the role which the Farm Credit System has chosen for itself.

The system is developing that role, and it is becoming much more centralized. Over time, if assisted without limitations, if, in effect rewarded for its difficulty, it can become aggressive again.

Private agricultural banks welcome competition, but it must be fair competition. Competition from a federally assisted nonbank bank seeking to offer additional services while retaining special access to the credit markets is unfair.

The American Bankers Association does not believe that assistance should be offered by the American taxpayer without some significant changes in the operation of the System designed to target and limit its activities, tighten its district level management to protect the soundness of the System, and strengthen and make independent its regulator.

The ABA has developed criteria for the evaluation of farm credit legislation, and I will present each one and discuss it briefly.

First, a strong independent regulatory agency must be established for the Farm Credit System. Simply giving additional regulatory authority to the Farm Credit Administration is not sufficient.

Farm Credit Administration must be made independent with an independent board and no management responsibility.

Independent audits of the Farm Credit System and its components must be required. The failure to have independent audits is a management shortcoming that harms management's ability to make decisions.

The Farm Credit System's capital requirements must be carefully defined and made comparable to those of other institutions.

These requirements are carefully defined for commercial banks and should be equally carefully defined for the Farm Credit System.

The System's internal practices assuring soundness must be made stringent. There has been great variation between districts on loan limits as a percentage of capital, just for example.

These requirements are established by bank regulators for banks and should be established for the entire Farm Credit System.

Proposals for a short-term response to a deteriorating agricultural credit situation should not confer long-term competitive advantages on the Farm Credit System vis-a-vis commercial banks.

This is the logical corollary of the discussion earlier in this testimony of the importance of Congress' consideration of the role that it wishes the Farm Credit System to play in agricultural financing in the future.

Any assistance package must provide equality of treatment for agricultural borrowers. The ABA objects to any short-term response to the deteriorating agricultural credit situation which would disadvantage borrowers at commercial banks relative to borrowers at the Farm Credit System.

Small rural agricultural banks do not have the System's ability to share their losses. The ability of agricultural banks to serve their borrowers is affected by loan losses just as is the ability of the Farm Credit System.

The Farm Credit Council has proposed a restructuring and financial assistance package to Congress. I don't intend to spend a great deal of time on that here, but there are several points which the ABA objects to.

The first objection is to the matter of the future role of Farm Credit System that the new authority granted under the bill would make possible.

The proposal would grant great power to the recently chartered capital corporation, and these powers would remain after the current Farm Credit System financial problems have been resolved.

With this added authority the System would have created what Project 1995 called a central entity that would act like a bank holding company on a nationwide basis.

The ABA believes Congress should carefully examine such a proposal to determine whether this long-term centralization is the appropriate role for a cooperative quasi-governmental agency.

Farm sector assets have been decreasing since January 1981, expecially in the Midwest.

Banks have problems in dealing with this decline. The FDIC problem bank list now includes 1,097 problem banks, up from 884 last year. Approximately 37 percent of these banks are agricultural banks.

Further, the 100th bank failed in 1985, last Friday, November 8; 50 of the 100 have been agricultural banks.

Mr. Chairman, the ABA has examined proposals for assistance that would help lenders work with their farm borrowers to stabilize asset values in this period of economic turmoil.

Three approaches seem worthy of further consideration. The ABA recommends that legislation designed to respond to the problems of agricultural credit is likely to include some combination of appropriation.

The first approach is a debt restructuring plan, designed to lower farmers' cash-flow requirements.

The second possibility is some type of corporation or warehouse that could be designed to hold farm assets off the market as they no longer perform.

If some way can be found to emphasize the conservation aspects of this approach, agricultural bankers believe it has merit.

But we are very concerned about its potential cost and the amount of land which might end up in any such corporation. These issues should be examined very carefully.

The third option is some mechanism that would provide Federal backing which would allow the Farm Credit System and commercial banks to spread losses on agricultural loans over time.

It should be carefully structured to provide lenders time to practice forbearance for the farmers.

However, it should not simply grant continued existence to institutions that are now in difficulty because of agricultural loans.

Mr. Chairman, members of the committee, the ABA has been working diligently on the issues of agricultural credit for months and expects to continue to do so.

We can't say we look forward with great joy to the opportunity to work with you on these problems, because there is no joy in this situation.

However, we respect your concern for the situation of the farmers and lenders now involved in agriculture, and we look forward to working closely with you.

[The prepared statement of Mr. Taylor follows:]

STATEMENT

OF

TIMOTHY TAYLOR

on behalf of

THE AMERICAN BANKERS ASSOCIATION

on

AGRICULTURAL CREDIT PROBLEMS

before the

SUBCOMMITTEE ON ECONOMIC STABILIZATION

UNITED STATES HOUSE OF REPRESENTATIVES

NOVEMBER 14, 1985

Mr. Chairman and Members of the Committee, I am Tim Taylor, President of First of America Bank-Holland, Holland, Michigan. I am representing the American Bankers Association, and I am the Chairman of the American Bankers Association Government Relations Agricultural Task Force this year. The combined assets of our nearly 13,000 member banks represent approximately 95% of the industry total. While our members range in size from the smallest to the largest banks, approximately 85% of them have assets of less than $100 million.

I do want to thank the Economic Stabilization Subcommittee for its interest in these agricultural credit issues. They are of great importance to the banking industry. The involvement of the Banking Committee and hearings like this one are encouraging to agricultural bankers. The problems of agriculture are affecting commercial banks and those problems, in turn, affect agriculture. Because of this interrelationship, the ABA supports the involvement of the Banking Committee in the current issue of agricultural credit and the problems of the Farm Credit System.

Mr. Chairman, farmers, agricultural banks, and the Farm Credit System all are facing the same deteriorating agricultural economy. In the history of this country, farm problems are not unusual. In most cases, these problems are corrected by normal economic cycles which cause the agricultural industry to rebound and recover. However, this time we have some structural changes occurring within the agricultural industry that normal economic cycles will not correct without massive social and economic dislocation. These problems threaten the existence of a significant percentage of farms and an unknown but growing number of agriculture-related banks and businesses.

Economic problems of a size not seen by generations of Americans are wrenching farm life and rural communities across the country's principal food-producing regions. Evidence is mounting that fear and despair are spreading among hundreds of thousands of farmers who are looking at millions of acres of farms likely to fall into the hands of creditors. These farmers are among the nation's more than 2 million farmers who are struggling to pay interest on total liabilities that have soared 63% since 1979, from $132 billion to $215 billion in 1985. The interest now totals more than $21 billion a year, while net farm income is projected to drop by 28% from 1984 ($34.5 billion) to 1985 ($25 billion).

I am here today to discuss once again the deteriorating agricultural credit situation. I shall discuss also the current status of the Farm Credit System (FCS) and proposals for its assistance.

Let me assure the committee that the ABA does recognize the severity of the problems facing the FCS. We empathize because agricultural bankers face the same problems: declining farm income and asset devaluation that result in intensified farm credit problems.

We recognize that the basis of the farm financial problem is declining income, and that credit cannot be substituted for income. As I stated earlier, we are witnessing a structural transformation of our agricultural industry, which is now over-capitalized based on income projections for the foreseeable future. In this context, farmers, agricultural suppliers and creditors must be given time to adjust to the current environment of deflation of assets, high real interest rates, and the over-priced dollar. There are no easy answers, no quick solutions, only different proposals for sharing the pain.

But we are here today to focus on credit and the Farm Credit System. The ABA supports the survival of the FCS and recognizes that Federal assistance may be necessary. But we urge the committee to view the agricultural credit situation and the Farm Credit System's proposals for assistance from two perspectives. First, survival of the System is a short term goal of both the System and agricultural bankers. Second, however, any Congressional response to this short term goal has long term implications for the role of the FCS in relation to commercial banks and the structure of agricultural financing in the future. These implications cannot be ignored.

ROLE OF THE FARM CREDIT SYSTEM

The ABA has testified numerous times to object to an ever-broadened mandate for this cooperative financial institution. ABA testified four times before the House and Senate during hearings on the System's proposals for expanded authority in 1979 and 1980. We also expressed our concern about lax regulation by an agency, the Farm Credit Administration, that was not independent. During the mark-up of the Farm Credit Act Amendments of 1980, members of the House Agriculture Committee noted their concerns about the liberalizing amendments that were passed. However, they were passed. The Farm Credit System then began a major study of its future, its structure, and its role in agricultural finance titled "Project 1995".

Today, the Congress is faced with a very difficult situation concerning this same FCS. The System is requesting a major assistance package and implying that if assistance is not approved within a very short time that total collapse of this large financial institution will result.

From one perspective, this is obviously the worst time to raise the question of what the role of the Farm Credit System should be. But from another perspective, it is precisely the time at which this question must be asked. If the question is not asked, and if the Congress responds with an assistance package, then the Congress will be affecting the long term picture of agricultural credit in this country without assessing the goal which it finds most acceptable for the System that it is assisting and for which it is responsible.

There are internal changes going on within the Farm Credit System that are remaking the System's structure, changing the locus of decision-making, and potentially increasing the range of services offered in competition with agricultural banks and other lenders. These changes are going on, and there is a game plan outlined in "Project 1995" for these changes. If the Congress does not consider the role that it wishes the Farm Credit System to play in agricultural lending as it develops an assistance package, it will be confirming, by default, the role which the Farm Credit System has chosen for itself.

The System is developing that role and it is becoming much more centralized. Over time, if assisted without limitations, if, in effect, rewarded for its difficulty, it can become aggressive again. Private agricultural banks welcome competition, but it must be fair competition. Competition from a Federally-assisted non-bank bank seeking to offer additional services while retaining special access to the credit market is unfair.

The American Bankers' Association acknowledges the importance of the Farm Credit System and recognizes the need for assistance. However, we do not believe that assistance should be offered by the American taxpayer without some significant changes in the operation of the System designed to target and limit its activities, tighten its district-level management to protect the soundness of the System, and strengthen and make independent its regulator.

In addition, since the System is a cooperative with privileged access to the credit markets due to its Federal agency status, which results in the market's perception of Federal backing, the Congress should consider how the System's role as a cooperative lender is going to be pursued in the future. Otherwise, the System will retain its tax advantages as a cooperative and credit market advantages as a quasi-governmental agency, receive new Federal assistance due to its financial difficulties, and yet be able to continue its restructuring and redefinition of its role unchecked. As this committee certainly knows, there is considerable objection to many current FCS policies (such as consolidation and foreclosure) based on the argument that these actions are not consistent with a cooperative enterprise, controlled by farmer-borrowers at the local level.

If the Congress determines that the direction in which the System is now going does not fit the role deemed appropriate for a cooperative agricultural lender, then changes and limits should be applied to any legislation providing short term assistance for the System. Careful strictures applied to the System will define its role for the long term future. Such strictures should be applied now when the assistance is being requested from Congress and the general public.

Since the FCS was first set in place, numerous changes have occurred in the financing of agriculture, including increased participation by the private sector. For example, banks had 14% of the loan volume outstanding in 1940, but had 24% of all agricultural loans outstanding this year according to the Federal Reserve. We believe the appropriate role of the FCS has changed, and that this role should be re-evaluated by the Congress.

Such an evaluation, we believe, will demonstrate that a greater reliance on the private sector will best meet the future needs of the agricultural economy.

CRITERIA FOR EVALUATION OF FARM CREDIT LEGISLATION

The ABA has developed criteria for the evaluation of farm credit legislation. I shall present each one and discuss it briefly.

- A strong, independent regulatory agency must be established for the Farm Credit System. The ABA strongly supports the development of an independent agency with strong enforcement power for the regulation of the Farm Credit System. Whether that agency is a totally remade Farm Credit Administration or some other body is not of fundamental concern. Our primary concern is that the regulatory agency be independent and function vis-a-vis the Farm Credit System in the same manner as the bank regulators function vis-a-vis banks. Simply giving additional regulatory power to the FCA is not sufficient; the FCA must be made independent with an independent board and no management responsibility for the System.

- Independent audits of the Farm Credit System and its components must be required. As a number of independent analyses by the General Accounting Office and various reporters have demonstrated, the Farm Credit System at present does not have careful, systematic, independent audits that would provide the type of consistent and thorough data required to craft legislative responses to its financial situation. The failure to have independent audits is also a management shortcoming that harms management's ability to make decisions. Independent audits are an absolutely fundamental requirement, in our opinion, for any financial institution, but particularly for one directly overseen by the U.S. Congress.

- The Farm Credit System's capital requirements must be carefully defined and made comparable to those of other financial intermediaries. One of the major questions raised concerning assistance packages designed for the Farm Credit System is what is the extent of its capital and in what form is that capital held. These requirements are carefully defined for commercial banks and should be equally carefully defined for the Farm Credit System. The failure to specify these criteria would leave Congress without the type of information which it needs when dealing with this large financial institution and would leave the System without guidelines for the future.

- The Farm Credit System's internal practices assuring soundness must be made more stringent. Apparently, the Farm Credit System is now establishing internal practices nationwide to assure the soundness of the system in the future. However, there has been great variation between districts — on loan limits as a percentage of capital, for example. These requirements are established by bank regulators for banks and should be established for the entire Farm Credit System.

- Proposals for a short term response to the deteriorating agricultural credit situation should not confer long term competitive advantages on the Farm Credit System vis-a-vis commercial banks. This criterion is the logical corollary of the discussion earlier in this testimony of the importance of the Congress' consideration of the role that it wishes the Farm Credit System to play in agricultural financing in the future. Providing assistance only to the Farm Credit System confers a long term competitive advantage on the System by definition. The ABA believes strongly that a System that is today a major competitor to the private sector and which wishes to strengthen its competitive position in the future while still maintaining the benefits of a cooperative, quasi-governmental financial institution must be carefully examined by the Congress. Any short term assistance package must be targeted and limited.

- Any assistance package must provide equality of treatment for agricultural borrowers. The ABA objects to any short term response to the deteriorating agricultural credit situation which would disadvantage borrowers at commercial banks relative to borrowers from the FCS. Assistance to the FCS will naturally result in indirect assistance to the farmers who borrow from the FCS by relieving certain economic pressures on the System. We strongly believe that agricultural borrowers from other institutions should have the same opportunities as borrowers from the FCS. As stated earlier, agricultural banks are facing the same agricultural economy as the FCS. In addition, small, rural agricultural banks do not have the System's ability to share their losses with other parts of the institution in less financially-distressed areas of the country. The ability of agricultural banks to serve their borrowers is affected by loan losses just as is the ability of the FCS. All farm borrowers should be treated equally in any assistance package.

FARM CREDIT COUNCIL PROPOSAL

The Farm Credit Council has proposed a restructuring and financial assistance package to the Congress. I do not wish to spend a great deal of time on this proposal, but there are several key points in it to which the ABA objects. A first objection is to the future role of the FCS that the new authority granted under the proposal would make possible. The proposal would grant great power to their recently chartered Capital Corporation, and these powers would remain after the current FCS financial problems have been resolved. In effect, this proposal would place a new, powerful, permanent central management controlled by a board comprised of hired managers, currently the 14 presidents of the System's 37 banks. Under the Capital Corporation's Articles of Incorporation, the Capital Corporation has the power "to exercise all authorities and powers of the Banks under the Act consistent with the purposes of the Corporation." (Article IV, Section 24).

The proposed legislation would ratify this power and add the following powers among others listed in the Council's draft legislation titled the "Farm Credit System Self-Help and Federal Assistance Act of 1985":

- to assess System institutions

- to borrow from any lending institution
- to "issue its own notes, debentures, or similar obligations"
- to "join with System banks in issuance of System-wide notes, bonds
- to "supervise to the extent it deems appropriate, local administration, servicing, and restructuring of loan and loan-related assets . . ."
- to "loan money to any person who is a borrower of any System institution and whose loan has been sold to . . . or participated in by, the Capital Corporation"

With these powers the Capital Corporation would control the commingling and re-deployment of the earned surpluses of the 37 banks within the System and the use of the $6 billion of Federal assistance which the Council requests.

No standards are specified by which the commingled funds and the Federal money are to be used, either for the benefit of the 37 banks or for the benefit of the farmers who borrow from them.

With this added authority, which would continue beyond the present crisis situation and which is not limited to a time when federal assistance would be outstanding, the System would have created what "Project 1995" called a "Central Entity" that would act like a bank holding company.

The ABA believes that Congress should carefully examine such proposed changes to determine whether this long term centralization is the appropriate role for a cooperative, quasi-governmental agency. This Congressional examination is especially important when combined with the Council's request for $6 billion of appropriated funds to be controlled by the FCS. The legislation would direct the Governor to release up to $2 billion a year to the System and specifies that funds would be appropriated for the governor to reimburse the Treasury. As stated earlier, the ABA supports using any direct federal assistance to provide equitable treatment for all farm borrowers. We oppose any direct financial assistance that only aids borrowers from the Farm Credit System.

The ABA urges members of this committee to carefully examine any proposals for financial assistance to, or restructuring of, the FCS. Proposals such as this one by the System are unfair to farm borrowers from commercial banks now and would set the stage for unfair competition to commercial banks in the future.

ASSET STABILITY

Because real estate constitutes 75% of total assets, changes in the value of farm land will dominate all changes on the asset side of the farm balance sheet. Farm sector assets have been decreasing since January, 1981 especially in the Midwest. In one of the states experiencing the greatest decline, Iowa, most recent USDA figures show that farmland values have declined 49 percent since 1981.

Banks are having problems dealing with this kind of decline. We find a tremendous increase in the number of problem banks and bank failures. The percentage of these banks that are agricultural banks has increased also.

The FDIC problem bank list now includes 1097 problem banks,up from 848 last year. Approximately 37% (406) of these are agricultural banks. Further, the 100th bank failed on Friday, November 8; fifty of these failures were agricultural banks. Assisting farmers and lenders to stabilize assets can prevent some of the more extreme problems for rural communities. It can prevent farm failures and bank failures.

Mr. Chairman, the ABA has examined proposals for assistance that would help lenders work with their farmer-borrowers to stabilize asset values in this period of economic turmoil in agriculture. Three approaches seem particularly promising and worthy of further consideration. The ABA recognizes that legislation designed to respond to the problems of agricultural credit is likely to include some combination of approaches. The problems now endemic to the agricultural economy make for a complex and multi-faceted situation to which there will be no single, straightforward response. It is in this context that I present these three possible responses for your consideration and, we hope, further review.

- One approach is a debt restructuring plan designed to lower farmers' cashflow requirements. Agricultural bankers are willing to take part of the burden of restructuring debt in order to keep farmers on their farms and to keep land in the hands of farm families. A proposal which would have the Federal government, state government, and lenders participate in debt restructuring seems a very reasonable and workable solution for some farm families.

- A second possibility is some type of corporation or "warehouse" that could be designed to hold farm land off the market when loans on that land are no longer performing. Holding land off the market is a benefit because the more land that is placed on the market the more the market becomes depressed. Holding land off the market will help prevent a spiralling deflation of land prices. If some way can be found to emphasize the conservation aspects of this approach, agricultural bankers believe it has merit. But we also are very concerned about its potential cost and the amount of land which might end up in any such corporation. These are issues that should be very carefully examined if further consideration is to be given to this approach.

o A third option is some mechanism that would provide Federal backing which would allow the Farm Credit System and commercial banks to spread losses on agricultural loans over time. Such a mechanism would assist regulators as they examine these agricultural financing institutions. It should be carefully structured to provide time for lenders to practice forbearance with farmers so that both farmers and lenders have an opportunity to work out of their current financial difficulties. However, it should not simply guarantee continued existence for all institutions that are now in difficulty because of agricultural loans.

Mr. Chairman, members of the Committee, the ABA has been working diligently on the issues of agricultural credit for months and expects to continue to do so. There are no short answers to a problem that has been developing for the last fifteen to twenty years. We cannot say that we look forward with great joy to the opportunity to work with you on these problems because there is no joy in this situation. However, we respect your concern for the situation of the farmers and the lenders now involved in agriculture. We look forward to working closely with you.

Chairman LAFALCE. Thank you very much. Mr. Wilkinson, what is your salary?

Mr. WILKINSON. My salary is $73,800.

Chairman LAFALCE. What is the highest salary within the——

Mr. WILKINSON. Correction, Mr. Chairman, $73,600, to be specific.

Chairman LAFALCE. What is the highest salary within the Farm Credit System?

Mr. WILKINSON. The Farm Credit System, which is a private structure, has its own salary schedule, and to my knowledge, the salary, the highest salary is $205,900, Mr. Chairman.

Chairman LAFALCE. Is that more than the President of the United States makes?

Mr. WILKINSON. I do not know. This is not one of the bank presidents. This is the individual that handles the funding corporation.

Chairman LAFALCE. I will leave that to others to pursue if they desire. Mr. Shumway is interested.

I had heard rumors Bill Isaac might be with the Farm Credit System, they couldn't understand why. Now I can understand, especially if some new type of credit capital corporation were to be created. Mr. Wilkinson, there was a point in time when you said the Farm Credit System could handle its own difficulties and that there was no need for additional Federal financial assistance. When was it that you were of that persuasion?

Mr. WILKINSON. During the spring of 1985 and on into the summer, Mr. Chairman.

Chairman LAFALCE. How far into the summer?

Mr. WILKINSON. Specifically, until about September 1.

Chairman LAFALCE. All right. What happened between August 31 and September 1 that made you change your mind?

Mr. WILKINSON. My statement and that of the agency, as well as the Federal court, had always been predicated on two caveats. No. 1, was that there would be no further down-trending of the agricultural sector beyond what we had projected in our stress studies, and, No. 2, that the System would have the ability to administer its own resources in a way that could make full use of those. I think you may remember that in August, the department——

Chairman LAFALCE. Predicated on two things? What were those two things?

Mr. WILKINSON. Those two things were, No. 1, there would be no further down-trending of the agricultural economy beyond that which we had earlier projected in our rather intensive studies; and the No. 2, that the System would have the ability to fully utilize all of its assets. In other words, the ability to move its capital from one institution to another.

Chairman LAFALCE. Insofar as the utilization of its assets systemwide that is being called for by the Farm Credit Council, by the administration itself—if passed by Congress, that will shortly be fulfilled, correct?

Mr. WILKINSON. That would be of significance. It was not being done voluntarily, Mr. Chairman.

Chairman LAFALCE. Surely. But I am also told now that there is general uniformity of opinion, if not unanimity of opinion, that that should be done within the System itself. Is that correct?

Mr. **Wilkinson**. I think there is recognition it may need to be done, but I am not one to evidence to you it would be done voluntarily by all system institutions.

Chairman **LaFalce**. I am not suggesting that I am suggesting insofar as the legislative proposals being discussed, there is general backing.

Mr. **Wilkinson**. Yes, sir.

Chairman **LaFalce**. We won't do it voluntarily, but we will support legislation to be enacted that would mandate us to do that.

Mr. **Wilkinson**. That is correct, sir.

Chairman **LaFalce**. Let's go to your first assumption, then. You said it was based upon the assumption there would be no further down-trending in the farm—or the agricultural economy other than that projected. So what down-trending were you projecting in June, July, and August. What down-trending did you see and project September 1?

Mr. **Wilkinson**. We were projecting little or no improvement in commodity prices. We weren't anticipating large crops. But to answer your specific question, Mr. Chairman, the one significant factor that we had not fully anticipated was a continued very rapid decline in land values, by reference, $181 billion drop in land values, $100 billion of that being within this past year. The Farm Credit System was basing its ability to handle——

Chairman **LaFalce**. You knew that in June, July, and August, didn't you?

Mr. **Wilkinson**. We did not know. We were conducting studies at the Farm Credit Administration. The System was conducting its own study of the collateral values of its Federal land bank loans. The trends taking place, until those studies became available, we did not realize——

Chairman **LaFalce**. When did they become available?

Mr. **Wilkinson**. They became available—we began seeing the reports in the first part of September.

Chairman **LaFalce**. When were they available to others?

Mr. **Wilkinson**. The system had its report the end of August, about the same time.

Chairman **LaFalce**. All right. About a month or so ago, it seems to me, people from the Farm Credit Administration were asking for about $10 billion in Federal help. Yesterday the Farm Credit Council said $6 billion was needed, but did not dispute the administration's claim that the System's earned surplus and loan loss reserves exceeded its expected losses through 1987.

Today you suggest Congress should promptly approve a $5 billion line of credit. First, how did you arrive at the $5 billion figure as opposed to the $6 billion or to the $10 billion or the zero figure? Second, how would the System use those funds for that line of credit?

Mr. **Wilkinson**. Mr. Chairman, I am not in a position to respond as to the System's development of its own proposal or how it would use its funds, but I can speak to how FCA would propose it be done.

Chairman **LaFalce**. That is precisely what I want you to do.

Mr. **Wilkinson**. FCA, in the evaluation of what kind of financial assistance is needed, very specifically has always referred to a line of credit, a backup line, which would mandate full utilization of the

System's own resources and would stand only when and if needed by the system as determined by the Farm Credit Administration.

Chairman **LaFalce**. Is this in contradiction to a position we heard yesterday with the Farm Credit Council? Are they different or the same?

Mr. **Wilkinson**. This is different than the Farm Credit System's proposal, and I think it is important that you recognize that. We are speaking as the regulator of that system.

Chairman **LaFalce**. Please proceed.

Mr. **Wilkinson**. The $5 billion is what we believe would be needed at a given time after the System has used its reserves, its earned funds, its reserves for losses, which we indicated are between $5.3 and $5.5 billion. This would not tap into the class B stock, the capital investment of the borrowers of this system, for we have always felt this would be creating an undue burden upon the agricultural sector.

Chairman **LaFalce**. First of all, if we are going to do anything, I am much more inclined to your position than the position we heard yesterday. I wanted to bring out, there is a decided difference. We are not going to hand something over to the Farm Credit System and say you make your decisions, fellows, whatever you want. And surely there would have to be first recourse to their surplus.

But what about the borrower's stock, should we just hold everybody harmless and shouldn't the pool be required to sacrifice a bit if the taxpayers are going to be called upon to sacrifice a bit? Isn't that what was done by this subcommittee in the New York City situation, in the Chrysler situation? Isn't it a pretty good principle so that you don't have individuals think they can go to the Federal Government and get assistance without hurting themselves?

Mr. **Wilkinson**. I think you have to define the difference of the farmer's own earned equity here, that $5.3 billion, and our agreement with you that that should be utilized to the fullest possible degree.

When you go beyond that, Mr. Chairman, you are generating some extremely severe impacts upon many farmers across this Nation, good and bad farmers.

Chairman **LaFalce**. Wait a minute, if someone comes asking for help and you give them 80 percent of the help that they desire, it is tough for me to accept the premise that we are inflicting injury upon them. I mean, who is inflicting injury upon whom? Perhaps they have inflicted injury upon themselves.

If we are going to assist, we want to lessen the injury. If we lessen the injury, don't blame us for the injury that remains.

Mr. **Wilkinson**. Your basic problem here is that you would begin to utilize the stock investment of the farmers. You would truly be damaging the good farmers, 90 percent of the borrowers of the Farm Credit System, who have maintained their payments in proper fashion.

Chairman **LaFalce**. Who chose to participate within, basically, an insurance pool.

Mr. **Wilkinson**. Who chose to participate in a proper credit institution.

Chairman **LaFalce**. Which has inherent risk within it.

Mr. **Wilkinson**. Yes, sir. Yes.

Chairman LAFALCE. Now, we want to hold them harmless from that risk.

Mr. WILKINSON. The basic question is the one I cited, and that is to what degree does the Government believe that it needs to provide some kind of assistance to the overall agriculture sector, and how much of it should be done through its credit institution?

Chairman LAFALCE. All right. Fine. Why should we help the agricultural sector, if we are not coming up with some bank for the manufacturing sector? There has been general opposition on the part of the administration to any national development bank. I proposed a bank for industrial competitiveness. It could have been of special help to the manufacturing sector. They said, "Oh, no. That is the free enterprise system." Why should we have special assistance to the agricultural sector when we think it is anathema to the free enterprise system to be of assistance to the manufacturing sector?

Mr. WILKINSON. I think you have to ask the question, especially as you look at the real estate marketing side of the agricultural sector, where would the some $40 billion be available, where would it come from and be available to the farmers and ranchers of this country as they attempted to secure their long-term credit arrangements?

This was the origin of the Farm Credit System. It is still a great need today, because you do not find many in the other sectors in this area.

Chairman LAFALCE. Mr. Wilkinson, we have Mr. Taylor and Mr. Gerhart there, and, basically, they are saying we think you ought to give something to the Farm Credit System, but you shouldn't give anything to the Farm Credit System unless you give something to us, too. We want ours. I think that is a fair characterization of what they are saying. Whatever we do, make sure we get ours.

Mr. Wilkinson, why should we give you something and not give them something? You know, they are borrowers, the same borrowers that have gone to the Farm Credit System. They are creditors, the same way that you are—the Farm Credit System is a creditor; and, actually, we have already given a full-faith and credit backing, at least to a limited amount, to their banks, and we have no legal obligation to the Farm Credit System.

Mr. WILKINSON. You are correct. You have no legal obligation to back the investors' securities, which they have purchased. I truly believe there is a moral obligation, Mr. Chairman, because the Farm Credit System is considered one of the agencies, as you——

Chairman LAFALCE. The difficulty is we have so many moral obligations—should we look in the multitude of moral obligations that we have to those that we also have a legal obligation and discharge those first?

Mr. WILKINSON. I think if I heard properly, Mr. Chairman, I heard both of my colleagues at this table evidence their support for the continuation of a Farm Credit System.

Chairman LAFALCE. Oh, sure, they hold half your bonds.

Mr. WILKINSON. That is correct, and I am appreciative of the fact that is recognized, because the demise of the Farm Credit System would have a very significant impact upon the total financial community in addition to, of course, the agricultural sector.

Chairman LAFALCE. All right. Mr. Taylor, Mr. Gerhart, why should we be of assistance to ag banks when we have an awful lot of banks that got into difficulties because of real estate loans other than farm real estate, when we have an awful lot of banks that got into difficulty because of Third-World debt loans, because of energy loans, an awful lot of banks that got into difficulty because of inability to diversify or because of their inability to expand geographically?

If we are going to come forth with assistance to the Farm Credit System, you argue we should come across with assistance to ag banks, but isn't it the position of the ABA and IBAA that we should be giving assistance to all banks? Or do you think those other banks the ABA represents, Mr. Taylor, and those other banks that the IBAA represents, Mr. Gerhart, who are in as serious financial difficulties as the ag banks are less worthy of our assistance?

Mr. GERHART. I will try to answer that. First of all, we believe the best way you can help the lenders is help the agricultural borrowers. That is our basic concern.

Why should we help the agricultural borrowers, I guess is the next question? Why do the farmers need help? I go back to the theory that we do have a relatively economic food policy in this country. The food cost to the American housewife is less than in other countries. Our farmers are suffering from things over which they have no control.

Chairman LAFALCE. You heard Mr. Wilkinson, most of their difficulties have to do with speculative investments and real estate. That was the primary change that gave birth to his change in opinion.

Mr. GERHART. In the area I serve, I didn't see that much. The prices went up, the people buying this land had either owned land or had to discontinue farming. They looked at a 20- or 30-year period of inflation. I know a number of people whose fathers died and they had to buy the land or get off the farm. It was unfortunate that the prices went up the way they did.

But I would disagree with the theory that we have a bunch of wild speculators out there. I think these were people trying to stay in business and to do so, they had to buy some land.

Chairman LAFALCE. We are on our third hearing on this. We had the Chief Economist of the Federal Reserve, we had the Chief Economist from the Farm Credit Administration, et cetera, and they thought one of the principal causes was speculative real estate investment. There is some discrepancy there.

Mr. Taylor, do you have some comments on why we should help ag banks but not on those other banks ABA represents? Why shouldn't we help the thrift institutions?

Mr. TAYLOR. Mr. Chairman, as I think that question through, and having been in a community where other economic disasters have occurred, it is personally a dilemma for me. On the other hand, I also know, having been in very small communities that are totally dependent on agriculture, that we are not dealing with just one sector and we are not dealing with one industry. We deal with communities who are dependent on agriculture for livelihoods throughout. It is just pervasive in those communities.

Towns of a thousand people or less, towns of 2,000 people, if the farmers are not available to buy in their towns, the grocery stores, the clothing stores, the whole gamut of retailing, as well as other job opportunities, are just going to disappear, and we are going to face massive economic and personal dislocation.

Chairman LAFALCE. My time has expired.

Mr. Shumway.

Mr. SHUMWAY. Thank you, Mr. Chairman.

Just to pursue that thought, I can appreciate the fact you are concerned about those small communities where agriculture may dominate. I represent a very rural district in California, and I have communities within my district that are built around perhaps a sawmill or perhaps a mine. I think you would agree the output of those industries is just as vital as the output from agriculture.

Yet when that sawmill closes or that mine can't operate, likewise the grocery store, the clothing store, the service station, they all close. So it is really difficult for me to adopt that as any kind of criteria here.

I think the chairman's line of questioning is very valid and one that we must answer if, indeed, we are going to pursue or march ahead with this idea of some kind of assistance to the farm credit industry.

Mr. Wilkinson, I would like to just go back to some of your recommendations briefly. You said basically the Farm Credit System needs expanded enforcement powers and additional ability to pool and manage resources and so forth. In connection with the expanded enforcement powers, I think you mentioned specifically the ability to exercise removal of officers and directors, I take it, serving within the Farm Credit System.

Mr. WILKINSON. Yes, sir.

Mr. SHUMWAY. The chairman asked a very pertinent question about salary. We saw a disclosure many weeks ago—many officers and directors within that system are earning salaries which, I think, by almost any measure would be deemed excessive. Within the enforcement authorities that you are seeking for your agency, would you have some degree of authority over the matter of salaries to officers and directors of these banks within the Farm Credit System?

Mr. WILKINSON. Not under the new authorities that we are proposing, Mr. Shumway.

Mr. SHUMWAY. Would you agree with me that if the Farm Credit System is going to present itself here and ask for some kind of Federal assistance, it should come forward with clean hands, with having a record of having done for itself everything that could possibly be done, including the reduction of salaries?

Mr. WILKINSON. Yes, sir. And they have faced up to some of that, sir.

Mr. SHUMWAY. We had a witness yesterday that discussed all of the self-help measures that have been taken, and I didn't see that particular thing. I am not hung up on that one issue but I did sit here when we went through the same kind of hearings with reference to the Chrysler Corp., some 7 years ago, and I remember one thing that really stuck in my craw at that time. Just before presenting themselves at this table, Chrysler had met with the UAW and granted excessive, I thought, wage increases to all of their workers. Then they came to the Federal Government and said, "Give us the money to pay those wage increases."

By and large, if the Farm Credit System is going to have the same kind of operating history, I think they could be charged with the same kind of unclean hands, and indeed the failure to exercise the kind of self-help, I think, that has to be characteristic from top to bottom of any proposal like this before Congress.

Mr. WILKINSON. Mr. Shumway, I agree with you, and I would indicate these salaries are determined by the farmer-elected boards of directors and those farmers are as concerned about the impact upon their interest costs as you are.

Mr. SHUMWAY. You ask also for increased examination and supervision powers as well as some ability to monitor corporate performance or perhaps oversee that performance with reference to shareholder rights. Maybe I misunderstood your statement in that regard.

But in that entire area, is there any indication that the problems we are now trying to deal with arise from deficiencies in those regards? In other words, regarding deficient examination and supervisory powers, you want more for your agency. But in giving you more, is that necessarily going to be a solution, even in part, to the problem?

I haven't yet really seen examples of problems attributable to these deficiences. You know, you cite the fact of depressed land values and the bankers talk about low prices as one of the primary problems; yet you are asking for more supervisory and examination powers. I am just wondering how that will go into the overall solution, because no one has really said there is a great deal of deficiency in that regard.

Mr. WILKINSON. There are two points I would stress. First, I have indicated to you that it is the intention of the Farm Credit Administration to examine as thoroughly as possible all the institutions of the System. It has been our policy, in an effort to keep costs to farmers as low as possible, to allow the banks of this system to do much of that work at the association level with spot checking by the regulator. In good times, Mr. Shumway, that seemed to be satisfactory, but as farmers began to face stress and so, too, their institutions, we began seeing the fallacy of that.

So my first point is that the Farm Credit Administration intends to intensify its direct examination of the institutions in the same way that the Comptroller and the FDIC and others do.

Second, the point addresses your issue of supervision. We have several cases that we could cite. One I will cite specifically, indicating where our examination information of our staff evidenced the failure of the board of directors and, in turn, its management at the bank level, to correct the deficiencies that we were citing in our examination reports.

In 1978, Spokane banks, commercial fishing loans failed to follow credit administation standards. It took us too long through coercion and negotiation to bring about a change. We should have authority to remove bank presidents, which we do not—authority to remove boards, which we do not. This addresses your specific question, Mr. Shumway.

Mr. SHUMWAY. All right. Thank you.

In your proposal for a capital corporation that you have outlined here this morning, does that parallel the administration's proposal? They likewise are speaking of a capital corporation. Are there differences that you are aware of between theirs and yours?

Mr. WILKINSON. Generally, Mr. Shumway, it does parallel what I at this time understand the administration's concept to be. I would stress, however, that in our bill, we would exert rather rigid authority or control as the regulator over the capital corporation, unlike what you heard yesterday from Farm Credit System officials.

I have not yet seen the language of the administration's proposal.

Mr. SHUMWAY. Thank you.

Finally, Mr. Wilkinson, you have said that some kind of financial assistance up front, perhaps, or line of credit, will be appropriate. From your position, is there any intention to repay that kind of financial assistance and, if so, how will it be repaid and over what period of time?

Mr. WILKINSON. Mr. Shumway, never have you heard me nor FCA propose upfront funding for the Farm Credit System.

Mr. SHUMWAY. The line of credit——

Mr. WILKINSON. Ours is a line of credit available if and when needed. And, yes, it would be my presumption as Governor of this agency at this time, that it would be paid in much the same way which the Farm Credit System repaid its capital, its Government capital ending in 1968. It does have a very fine record in this area.

Mr. SHUMWAY. Mr. Gerhart, you have stressed in your testimony that the best solution here would be for the Government to continue to keep intact the Target Price Program, farm price supports, in fact perhaps even enhance them beyond the present levels. That position is obviously at odds with the position taken by the Department of Agriculture, is at odds with the farm bureau in my State of California, and is at odds with many of us who believe that we should be moving the farm sector to more of a free market economy rather than propping it up with target prices.

You said in that context, I think, that by doing that, we are going to help the borrower. It seems to me that over the long haul, that kind of approach to this problem does not help the borrower, but only exacerbates the inflationary pressures we have to live with. It invites further debt on the part of the Federal Government, which lies at the seat of many of our problems. It is just difficult for me to understand how you, as a banker, understanding the economy as I am sure you do, can come to us and say, "Give us more, put the target prices higher, keep the subsidies flowing," particularly when that is a contrary position to what this administration has tried to represent for farmers.

Mr. GERHART. I agree, the farm groups are not unanimous on this. It seems to me that the free market concept that is being espoused pits our farmers in this country against governments in other countries. Other governments are protecting their farmers, and it is very difficult for our guys to compete with that kind of competition. That is basically what I understand this free market as being.

The other part of your question, how can the Government keep pouring more money into farm programs? We are suggesting production controls are a vital part of this whole thing. We simply cannot produce more stuff than we can sell, and any viable farm program should help cut costs by lowering the amount of grain produced.

Mr. **Shumway**. Like the PIK Program did?

Mr. **Gerhart**. I am not much of an advocate of the PIK Program.

Mr. **Shumway**. None of us are.

Mr. **Gerhart**. I think production control is the way to do this. It is going to take a bit of time to do this.

Mr. **Shumway**. Finally, Mr. Taylor, let me ask you a question, and then I will be through. There appears to be some degree of relationship between those States that have the most restrictive banking laws, and those States in which either their private banks or the Farm Credit System has had the most difficulty, for example, States having restrictive branching and holding company laws. Have you seen any statistics in that regard, or does that strike true to you, or is it an idea we need to develop further?

Mr. **Taylor**. I have not seen statistics.

Mr. **Shumway**. You are not aware of anything the ABA may have?

Mr. **Taylor**. On the other hand, just as a matter of observation, coming from Michigan, where we have multibank holding companies, I can tell you that the stress we are experiencing in our State is not what it is in other States. Now, there is not necessarily a direct correlation, but there probably is some sort of relationship.

Chairman **LaFalce**. Mr. Taylor, I would ask you to go back to the ABA offices and try to come up with a fuller response to Mr. Shumway's question, if you could.

Mr. **Taylor**. Absolutely.

Mr. **Shumway**. Thank you, Mr. Chairman. Thank you, Mr. Taylor.

Chairman **LaFalce**. Mr. Carper.

Mr. **Carper**. Thank you, Mr. Chairman.

Gentlemen, I welcome you this morning and thank each of you for your testimony.

Mr. Wilkinson, I want to explore the regulatory aspects of this whole situation. I am fairly familiar with the work that the FDIC, the Federal Reserve, the Comptroller of the Currency, the Federal Home Loan Bank Board, and State bank commissioners do vis-a-vis regulating, examining State-chartered and Federal-chartered banks and S&L's.

A number of us, I think most of the people here, or members of the subcommittee, have cosponsored with me legislation to strengthen the examination process that takes place for banks, S&L's, and credit unions. Our focus has been on trying to improve the training of the examiners, to diminish the turnover that occurs for examiners so we end up with better qualified, more experienced examiners.

I would appreciate your doing two things for me: No. 1, talking to me about the examination process that is inherent in the regulatory process vis-a-vis the Federal Credit System, and No. 2 just talking to me a little bit about the quality of the examinations, the training of the examiners and the kind of turnover experience that we have with the people that are doing the examination work.

Mr. WILKINSON. Thank you, Mr. Carper.

The examination process is handled first out of our offices here in the Washington area under our Chief Examiner, who is directly behind me. We then have regional offices.

Our basic emphasis in examination in recent years has been at the bank level of the 37 banks, to examine their total operation, their operational requirements as well as their fiscal status. In addition, we have had examiners at the association level, as required by the law, once a year in the production credit associations, because unlike the land bank structure, it is the PCA that makes the direct loans to the borrowers, and we have been involved there, at a lesser degree, at the land-bank associations.

These examination reports, with a team of examiners, then are put together, presented to our management staff, then presented to bank staff, because of their supervisory responsibilities, and then taken to the district boards who we hold accountable for the operation of their banks and, in turn, their associations.

And it goes back to that question of Mr. Shumway's, where do we begin to achieve some accountability? We attempt to achieve it through the duly elected boards, elected by the farmers. That is a general picture of the examination process, I think, not unlike what we are aware of in the commercial banking and S&L area.

No. 2, your second question, we are anxious to do something we have never had the privilege of doing, and that is to assure ourselves there is greater correlation in training and in requirements in the examination role and the examiners themselves of the Farm Credit Administration with those of the other regulators, and we have a proposal in that area that I think would enable us to do that. Because our emphasis as a separate, true arm's-length regulator is to attempt to impose upon this private Farm Credit System the same requirements as you have coming from the other financial regulators.

This is our objective, Mr. Carper, and that includes training, and it includes the daily operation of our examination program. If you wish me to ask our Chief Examiner if there is anything further he would like to say, I will leave that up to you.

Mr. CARPER. Do you have anything?

What do we need to do legislatively to improve the examination process that is inherent within the Farm Credit System?

Mr. WILKINSON. Number one, you have to enable us to not only do the examination and do it as thoroughly as possible, but to make sure that there are the necessary corrections of the irregularities which would impinge upon the safety and soundness of that credit institution. Our basic problem has been accountability, bringing about change fast enough within the banks themselves, and the associations. It is too time consuming, there are too many losses accruing during that period of time, and we think that is a very significant factor.

Our authorities now frankly are on one extreme or the other, there is no intermediate kind of authority as there is with the other financial regulators. We can sever funding to the bank, but it is not the bank that suffers, it is farmer borrowers, because the Governor does have to certify the security sale in the Wall Street market. That is too severe.

I have just been handed a note, and I was trying desperately to think of the organization we would like to have permission to be part of, and that is, we would like to be a member of the examination council.

Mr. CARPER. We might be able to accommodate you there.

Mr. WILKINSON. Thank you.

Mr. CARPER. Do I have time for another question?

Chairman LAFALCE. Sure.

Mr. CARPER. Thank you.

In Mr. Gerhart's testimony, he had talked a little bit about the capitalization of the Farm Credit System, and he compared it, as I recall, to the capitalization of the average commercial agricultural bank. As I recall, he indicated that the System's capital totals almost 18 percent of the System's assets. Could you just take a moment and break that capital down for me into its various components?

Mr. WILKINSON. I will break it down this way, Mr. Carper. The capital stock, which was the issue we talked about earlier, this is farmer investment B stock in its cooperative credit institution, in 19—amounts to about $5.5 billion. The earned net worth within the System is $5.3 billion, in addition to that, the E allowance for losses of $1.3 billion.

The difficulty in comparing commercial bank capitalization requirements with Farm Credit System's capitalization requirements is the consideration you may wish to give to the capital stock of the owners, the borrowers themselves, and is that subject to impairment and to use if necessary? We have always indicated, sir, that it is at risk. It is at risk.

Mr. CARPER. You are talking about the capital stock?

Mr. WILKINSON. That was the capital stock of the—that is B stock.

Mr. CARPER. Under your recommendation for Federal assistance, where would the Federal Government step in and provide the capital? After the $1.3 billion has been utilized?

Mr. WILKINSON. No, sir; it would step in—we are proposing that much, and I don't have a definitive line, but much of the 5.2 earned reserves, earned capital, be utilized——

Mr. CARPER. First?

Mr. WILKINSON [continuing]. First. But that we have proposed Federal backup line of credit would be available before we would begin to utilize the capital stock of the owners.

Mr. CARPER. So——

Mr. WILKINSON. The B stock.

Mr. CARPER. At what point after the 5.3 has been liquidated, 1.3 been, and then the Government steps in?

Mr. EDWARDS. The reserve and the earned net worth system——

Mr. WILKINSON. The reserve for losses and earned net worths. The answer to your question is yes.

Mr. CARPER. I thought the chairman said very well my own sentiments with regard to having the Federal taxpayer step in before we call on the capital stock investment to be utilized. I would simply concur with his observations on that point.

Thank you again, all three of you, for your testimony today. I would like to ask at this time whoever is the chief examinations person making a point of giving me a call. What we would like to do is address the other issue, improving the examination process.

Mr. WILKINSON. We will do that, sir.

Chairman LAFALCE. Mr. McCandless.

Mr. McCANDLESS. Thank you, Mr. Chairman.

Gentlemen, I appreciate very much the opportunity of you presenting your position today and the exchange that takes place. I think this is basically to the legislative process. So if I come on a little strong in certain areas, please, there is nothing personal in it.

I listened very intently to the chairman and the questions that followed his line of reasoning, which were somewhat mine. Then I went back to your testimony, Mr. Wilkinson, in which you said that during the period 1970 to 1980—this is on page 4 of your testimony—farm real estate assets tripled during that decade, increasing from $215 billion in 1970 to $755 billion 10 years later, with returns that marked generally favorable return on investment, terminology that you used.

Then you followed up by saying that the story of the 1980's is well known and that erosion of real estate values have brought on—had a great deal to do with what we are currently talking about and has brought on the current situation. It appears obvious to me one of the basic things in business is something is only as good as the return it produces on the investment it represents, and that a demise of the values of these farmlands is directly reflective of the fact they cannot produce a commodity that justifies the inflated price which was created at a time when subsidies and price supports and everything encouraged people to go out and increase their holdings and reduce their equities and so on and so forth.

Having said that and coming from an area in southern California noted for its tourism, but yet No. 1 in agriculture as far as the income of the area is concerned, I have problems with my colleagues from other areas where they have all these price support subsidies when we deal in fruits and vegetables and cattle feeding. If there is a freeze, there is a freeze, and you go on to the next year. If there is a surplus and the surplus is caused by Texas and Florida all coming on at the same time buying through the same market and you are not able to handle that properly as far as your financial resources are concerned, you become the latest former farmer on the block.

Yet we are saying here that we need production controls, we need price supports, and we need all this. Well, if we have all this, but we cannot dispose of the commodity for a profit that would give a return on the investment, what is the point of going through all this exercise?

Mr. Wilkinson.

Mr. WILKINSON. You are correct in recognizing the dramatic increase in resources, financial resources, which were placed into agriculture in the 1970's and the 1980's, and I think all lenders responded to that because at that time, at least in the Farm Credit

System, the loans that were made evidenced their repayment capacity. It was a very important factor.

Now, the basic problem that you are citing, I think, relates to the inability of the farmer or a sector of the American agriculture to plan carefully next year or the next decade as businesses should be able to plan——

Mr. McCandless. Can I interrupt? When you talk about agriculture, we have a very narrow tunnel in this area of subsidies, primarily in the grains and cotton. Isn't that—when we talk about your area here of planning, isn't that what you are talking about?

Mr. Wilkinson. I am talking about the overall sector of all of American agriculture, not just grain, livestock or dairy. But the point I am making——

Mr. McCandless. If I may again interrupt you, if I have 40 acres of citrus or 120 acres of table grapes, there isn't much to my planning, is there? Don't I have something I try to nourish and produce?

Mr. Wilkinson. No; you would be planning—this was the point I was going to make for a grain producer—on whether you would be able to secure the water rights, the subsidized water rights, for the irrigation of your 40 acres, or whether you would be able to acquire another 10 acres or 20 acres to expand to what you would presume to be a consumer demand.

You would have to at the same time, and I am very familiar with the California situation, you would have to evaluate whether the Government, the Federal Government or the State government, would allow your commodity, or those that compete in the marketplace through market order programs, to be able to have markets available.

Now, the commodities that are causing much of the stress in the Farm Credit System are under a different kind of agricultural sector. I am speaking of the livestock industry, of the upper Midwest, the grain industry of the upper Midwest. There is the inability of the United States to allow its agriculture to compete in world markets. It is the value of the dollar that has caused the——

Mr. McCandless. If I may interrupt. I hear a lot about this, and I don't know it is completely wrong, but when we have a law of supply and demand, where there is so much grain being produced that there isn't any way that it can be consumed and we are in competition with Argentina and other areas of the world for overseas markets, haven't we produced too much grain to begin with? Shouldn't we have said somewhere along the line, "OK, no more subsidies, no more production controls, no more price supports"?

We have developed the agricultural base through long-term development resources sufficient to feed the world, the United States, or whatever else; now we are going to do away with this concept of price supports, long-term financing other than what you can get on the marketplace as your people down the street and other areas, be it in the industry or whatever, and let it run itself.

If the production is good and you want to buy that other 20 acres you talked about, that is up to you. We are not going to support the prices on that other 20 acres you are going to buy.

Mr. Wilkinson. You have two basic problems, Mr. McCandless. One is that farmers too often are getting conflicting signals from their Government. One year it is one farm program, another year it is another farm program. Farmers are unable to bring about an adjustment process as rapidly as some other sectors are.

Mr. McCandless. Farmers in a certain area that you are talking about, you are talking about the grains and that kind of thing, where there are price supports——

Mr. Wilkinson. No; I am going beyond that. I am talking about farmers across the United States that have major investments in their harvesting, in their processing facilities, or their land may be useful only for one or two major crops. They cannot bring about an adjustment rapidly enough.

Mr. McCandless. The Department of Agriculture has nothing to do with fruits and vegetables other than inspect them in the area I come from. If you want to plant bell peppers instead of carrots, that is up to you.

Mr. Wilkinson. The Department of Agriculture has its Federal marketing orders, many of them in California.

Mr. McCandless. They do not restrict production, they control quality.

Mr. Wilkinson. Correct.

Mr. McCandless. I am not trying to badger you, it is just that I have a lot of problems with what we are saying here. Big brother government has to come in and loan more money to stretch out the equity problems and to handle the current financial situation. That is distressful, yet what are we going to sell to whom to pay these debts off that are going to be extended out and refinanced?

I came from a very competitive part of the business world, and my used cars and trucks were not subsidized by the Federal Government. If I didn't sell them, I had my own problem, and if the people didn't pay those conditional sales contracts I had my name on at the bank, it was my problem. I didn't have any price supports or anything.

So I have a little difficulty with this continual process of let's go ahead, business as usual, go on and on, not addressing the root of the problem, which I consider to be the merchandising of the commodities in question. If I sound like an editorializer, and I am, it is just what we are doing in the agricultural business--based upon my experience in the nonsubsidized agricultural business—is wrong, and we should get out of it as quickly as possible.

And the dairy farmers in my area want to do away with all subsidies, but the problem is that they are big, and they are productive, and they are efficient. The other parts of the country are not efficient, so they want this subsidy. I have a lot of problem with big brother, and I am sorry I bent your ear as I did, but I had to vent my spleen about production controls, price supports, can't sell bonds because the market wants higher prices for them. Sure they do, because you can't sell the commodity that is going to pay for the bonds. It is a 360-degree circle.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you, Mr. McCandless. I am going to have to recess this hearing, and Mr. Bereuter will be coming in shortly thereafter to resume the hearings, and he will be temporarily chairing it. I do want to get to one issue with both Mr. Taylor and Mr. Gerhart.

It seems to me that within both your testimonies, between the lines, there is this perspective that here the failure of the Farm Credit System is a dual opportunity.

For example, Mr. Taylor, in your testimony on page 4, you said the ABA recommends changes in the operation of the System designed to target and limit activities. I suspect that your major concern is the strength of your direct competitor, the Production Credit Association. So how do you want the activities of the FCS to be limited?

Mr. TAYLOR. Well, in response, our concern really relates to how the system would be restructured going forward. We do not want to put any focus on our institutions that is not a focus on benefit to our customers. To put our customers at a competitive disadvantage by giving something to the Farm Credit System that benefits their borrowers——

Chairman LAFALCE. Aren't your customers already in a competitive disadvantage? Isn't there a better interest rate they could get through the Farm Credit System—no?

Mr. TAYLOR. Not today.

Chairman LAFALCE. What about a year ago?

Mr. TAYLOR. In the past, there has been that disadvantage to our borrowers.

Chairman LAFALCE. How much of a spread was there when the financial solvency of the FCS was not questioned?

Mr. TAYLOR. At one point in time, and it varied from area to area, there were 200 basis points or more.

Chairman LAFALCE. 200 basis points or more. It is a fundamental question. Is it fair to have an FCS? Is there a need for an FCS? What do you think, Mr. Taylor?

Mr. TAYLOR. I think it is a very important question that needs to be addressed.

Chairman LAFALCE. What is your answer? We need it until the bonds are all taken care of and once that is——

Mr. TAYLOR. That would not be my answer. My answer is that in order for the commercial banks to replace the Farm Credit System, we need a funding mechanism for long-term credit.

Chairman LAFALCE. I am afraid I am going to have to recess, Mr. Bereuter will be coming shortly.

I am going to keep the record open to submit written questions to you that you can respond to.

One thing I do want you to go into is this fear that I sense you have of the competitive power that might come about through a Farm Credit Capital Corporation, which would perhaps be a holding company throughout the entire United States for the Farm Credit System that would be in direct competition with ag banks throughout the country.

It seems to me that you, Mr. Taylor and Mr. Gerhart, want to limit the power of the capital corporation, query whether that is in the national interest or not.

The subcommittee is in recess for about 5 minutes.

[Recess.]

Mr. BEREUTER [presiding]. I would like to start this again. With the chairman's permission, we will proceed with the questions and conclude after a rather brief series of questions I would ask of the panelists.

Thank you very much, gentlemen, for your testimony today. I am going to continue and complete this hearing with the permission of the chairman. As a special courtesy to me, he has given me an opportunity to do this, and because it is of key interest to me, the subject of this hearing, I very much appreciate the chairman's indulgence in this respect.

A special welcome to my constituent, Bud Gerhart from Newman Grove. This is the first time I have been able to welcome you before the Banking Committee in your new capacity or in any capacity.

Bud comes from the Norwegian capital of Nebraska where they have plenty of charisma. I believe that my instructions from the chairman are first of all before I get into questions to permit any of the three of you to respond to the previous question for the record and so if you could recall what that question was since I was out of the room, would any of you care to respond to that question?

Mr. WILKINSON. Yes.

Mr. BEREUTER. The capital corporation established by the Farm Credit System, apparently reservations were expressed from the IBAA and the ABA. Would you care to express those reservations more completely and perhaps Governor Wilkinson would like a chance to respond as well.

Mr. TAYLOR. Mr. Chairman, Mr. Bereuter, we did address that in our testimony on behalf of ABA. One of the key issues, it seems to me, that there is no structure in place today for a national bank holding company of any kind, and so to establish and create the powers for the Farm Credit System to go forward in that manner could create some unfair competitive environments.

That really was the thrust of our point.

Mr. BEREUTER. Mr. Gerhart.

Mr. GERHART. The question has to do with why we fear competition from this type of corporation. First of all, as you know, Doug, we feel that dealing with price and income is the only ultimate solution. If we don't get that we will be back year, after year, after year, after year talking about more Government money into the institutions. So until the borrowers get well, we will all be in trouble.

The competitive factor, we simply feel that our borrowers are entitled to the same kind of treatment as any other lender, including farm credit. If there is going to be Federal assistance, in forms other than through the farm program to help prices, we feel the banks and the borrowers of the banks ought to have equality treatment.

Regarding competition, what will happen when and if the Farm Credit System becomes a one-stop service—which is what they are talking about? We are seeing traditional life insurance and long-term lenders retreating from the farm real estate fields. What will happen to my borrower, for example, who is going to want to buy a farm down the road somewhere when he gets to where he can afford to buy one. I would say, go to the Federal land bank which has been the traditional lender over the years, and now we have a merged situation.

We have the Federal land bank and FCS as the same man. We naturally feel when that customer of mine goes down the road to get a land loan, he may have to take his operating credit line down there.

How will I compete with that?

I think that is the fear and concern that agricultural bankers have down the road. I would be willing to talk to Don Wilkinson about that.

Mr. **Bereuter**. I believe that part of the question, as I understand it, is that since there is concern about the financial warehouse for bad loans that has been established, are there ways that you would specifically recommend, either of you two gentlemen, Mr. Taylor, Mr. Gerhart, to meet your concerns about that particular type of institution or entity?

Do you have ways of solving the concerns that you have expressed either by broadening it or by some sort of a limitation upon it? Anything specific that you wanted to say in that direction?

Mr. **Gerhart**. The IBA feels that the warehouse could best be operated by the Farmers Home Administration because they have the expertise to do it. They have been in the business for years, and it wouldn't involve a new bureaucracy. It would be an impartial warehouse which would not necessarily favor either lender, but treat all lenders equally.

Mr. **Taylor**. The ABA does not have a proactive suggestion in this regard. We have concerns about it, and want to continue to look at it. But our view probably would go along the lines of being——

Mr. **Bereuter**. If you develop one soon, I would appreciate it and I am sure the committee would, if you would send it for inclusion in the record.

Governor Wilkinson, I believe you wanted to respond to that situation.

Mr. **Wilkinson**. Yes, Mr. Bereuter. I would urge my colleagues at the table, if at all possible, as rapidly as possible refer to the bill which we offered last week to the committees that deal with the issue of the capital corporation. We believe that we have addressed the concern of the commercial banking industry, for it is a different kind of capital corporation than that which is now in existence working in the Omaha district serving the Farm Credit System.

This capital corporation would be rigidly controlled by the Farm Credit Administration. It, of course, would be incorporated by the Governor of FCA. It would have very clearly defined purposes as it deals with the credit crisis today. Its board would be appointed by the Governor. They may be a mixture of public officials.

It would have very rigid control with our involvement as the regulator. It is in no way designed to lead in our estimation to what these gentleman may have as a future fear.

It is an emergency farm credit crisis vehicle to handle today's problems.

Mr. **Bereuter**. Thank you, gentlemen.

Now, moving briefly to the questions that I have to address to the panel, I might say, first of all, my colleague, Mr. Shumway made reference to concerns that he had about communities in his own district that would be totally dependent on a sawmill or a mining operation, for example, and I understand his concerns.

The point I would like to make is that we are talking about whole States, States of communities that are almost totally or totally dependent upon agriculture. So the economic dislocation there is extraordinary, particularly in States that have as much as 14 percent of their total population directly engaged in agriculture, not to mention those in agribusiness.

Yesterday, Under Secretary Naylor gave the administration's position on the Farm Credit System, and I would like to get the reactions of Mr. Taylor and Mr. Gerhart to several recommendations that he made about the Farm Credit Administration role as a regulator. I would simply read to you from two parts of his testimony, and see if you agree with the functions he would give the Farm Credit Administration as a regulator, and whether or not you would suggest other things beyond that.

This is a quote from his testimony:

> Restructuring the Farm Credit Administration into a true arm's length financial regulator, whose authority would include matters of entry and exit, capital, safety, and soundness and enforcement and supervisory directives.

And on a second point:

> Restructuring of present management board with a single chairman appointed by the President and confirmed by the Senate.

The latter perhaps is a little more specific than you want to be. But do you have any reactions to what he said at this point, the recommendations?

Mr. **Taylor**. Maybe you want to go first.

Mr. **Bereuter**. Mr. Gerhart.

Mr. **Gerhart**. I guess I don't have the benefit of having seen all that statement. Of course, the regulatory authority examination policies were certainly not opposed to—in fact we favor. The second thing, pooling of funds, it is our impression that they already—the Farm Credit System does have that type of authority and we are not sure why they need the pooling authority.

I think we are a little worried about where that is going to lead.

Mr. **Taylor**. Mr. Bereuter, our response would be one that would agree with the administration, and just emphasize the phrase, "arm's length." There is some evidence that with a board as it exists today made up of members from the System that one cannot function in an arm's-length role.

Mr. **Bereuter**. Thank you, gentlemen.

I have two or three duties for the record.

One is to mention that yesterday Under Secretary Naylor made comments about the availability of Farmers Home Administration loans and made reference specifically to operating loans, and my concerns were with the large backlog in acquisition loans which indeed are necessary, it seems, to this Member of Congress to provide some method of coping with the plummeting land values.

The second matter I wanted to refer specifically to is the letter attached to Mr. Gerhart's testimony from the presidents of the Independent Bankers Association of America and the American Bankers Association.

I would emphasize that this letter is very well-received by this Member of Congress because it lays out several reasons why the Banking Committee should have jurisdiction over proposals with respect to Federal assistance to the Farm Credit System. Summarizing it, they include the fact that some of the proposals require or suggest a loan or line of credit in an area where we by precedent, I think, have had legislative jurisdiction.

Second, that the Federal Reserve Board Chairman testified before this committee earlier this year that he was prepared to open the Fed's discount window to the Farm Credit System, and any legislation designed to assist the Farm Credit System should be examined by the Banking Committee in light of that pledge by Mr. Volker.

Third, the Farm Credit System has long been a direct competitor to the thousands of commercial banks that make agricultural loans, and therefore, they suggest that any assistance or reform proposal take into account the competitive positions of the Farm Credit System and its commercial bank competitors.

Finally, one purpose of the assistance would be to enable the Farm Credit System to continue to sell their securities in the Nation's bond markets, and that, of course, would affect potentially the Federal National Mortgage Association, the Federal National Mortgage Corporation, and their securities. So that would seem to me in my judgment a fourth point as to why the Banking Committee should have jurisdiction over some of the proposals for the assistance of the Farm Credit System.

Finally, to my colleagues who are absent, for the record, since this is a key matter of concern and in part the hearings were held for this member's benefit. I would like to mention also for the benefit of my constituent that, unfortunately, the Interior Committee decided to hear my bill on Indian gambling today. This is a controversial parochial interest to South Sioux City, NE, and that explains, I hope, my early absence from the hearings.

Again, thank you for your time, gentlemen, in behalf of the committee and for this member.

The hearing is recessed.

[Whereupon, at 11:50 a.m., the hearing was adjourned, to reconvene at 2 p.m. on Tuesday, Nov. 19, 1985.]

[The following letter of the American Bankers Association is submitted for inclusion in the record:]

AMERICAN
BANKERS
ASSOCIATION

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DIRECTOR LEGISLATIVE OPERATIONS
AND SENIOR LEGISLATIVE COUNSEL
J. Denis O'Toole
202/467-6655

December 9, 1985

Honorable John J. LaFalce
Subcommittee on Economic Stabilization
2220 Rayburn House Office Building
Washington, DC 20515

Dear Chairman LaFalce:

As was discussed with Staff Director Lee Price, we shall respond to questions 1,3,4,5,7,8,9,10,11 and 12 on the list of questions proposed by the subcommittee.

1. Do farmers still require the Farm Credit System (FCS) and all its parts? Can they find alternative sources of long- and short-term credit such that the government need not worry about protecting the FCS?

A. Farmers do require the Farm Credit System (FCS) now because there is no major alternative source of long term credit. For that reason the government must be concerned about the survival of the Farm Credit System for at least as long as it takes to develop a long term source of funds for commercial banks so that they can provide this long term real estate credit. Commercial banks are interested in this type of lending and ABA's Agricultural Bankers Division Executive Committee has taken a position in support of the development of a long term source of funds for commercial banks. Once that source of funds is established, there will be much less need for the continued existence of the Farm Credit System as a quasi-governmental agency retailing agricultural credit.

3. Does the government have an obligation to back the FCS as some of its bondholders may have assumed? How much financial assistance can and should the federal government provide to farm lenders under current law? Do the circumstances of the FCS warrant specific federal assistance not extended to ag banks, other creditors in stress, or other institutions dependent on the farm economy?

A. The ABA's position on the Farm Credit System is that it cannot be allowed simply to fail. The failure would have a major impact on bond holders of all types as well as a very serious impact on the FCS's farm borrowers. However, it is not clear that direct federal assistance is needed. If direct federal financial assistance is provided to the Farm Credit System, however, then ABA believes that in the interest of fairness such assistance should be made available to the borrowers from commercial banks as well as the borrowers from the Farm Credit System.

4. How much would the cost of credit to farmers differ if government gave financial assistance under current law, if it gave no assistance, or if it adopted different forms of financial assistance? If there is to be legislation, how much difference would it make if Congress completes action early next session rather than this session?

A. It is not clear how much the cost of credit to farmers would go up under various forms of assistance or if no assistance were given. It is clear that if bond holders are not reassured by some signal from the Administration, then the bonds will indeed cost more and some of this cost will be passed on to farm borrowers. However, it is not clear that even if direct financial assistance were provided to the System that the System would necessarily pass savings along to their borrowers. If the proper signals are sent to the market by the Administration now, it does not seem that legislation must be passed before Christmas but that it could wait until the next session.

5. Does the traditional 15 to 30 basis point spread between Treasuries and FCS bonds indicate that bondholders have been paid to bear some risk for holding FCS bonds? Should the FCS, as a large financial institution that depends almost entirely on agriculture, be treated differently from commercial banks whose largest farm lenders are much more diversified and whose most ag-dependent lenders tend to be much smaller? If current FCS bondholders were to be required to "take a hit," would that raise the cost of borrowing for federal agencies? If so, what would be the effects?

A. Part of the reason for banks' holding Farm Credit System bonds (which contributes to the demand for the bonds and the traditional 15 - 30 basis points spread) is the fact that these bonds may be held by banks without limit. At present there are no restrictions to the amount of bonds that can be held by commercial national banks or state member banks of the Federal Reserve System. The spread resulted partly from the demand generated by the failure of bank regulators to limit the amount of bonds banks may hold. Therefore, the risk was not perceived or stressed even by the bank regulators. The Farm Credit System, as a large financial institution involved in agriculture, is now treated differently from commercial banks and will continue to be treated differently with regard to their special tax status and their favored access to the credit market under any legislation now being considered. However, some assistance packages do not envision direct federal financial assistance. If direct federal financial assistance is provided, the ABA has taken the position that borrowers from both commercial banks and the FCS should be assisted equally.

If current FCS bond holders were required to "take a hit", it would raise the cost of borrowing for federal agencies because all purchasers of such bonds would be aware of the fragile nature of federal support for these quasi-governmental agencies' bonds.

7. How do the current supervisory/regulatory powers of the FCA differ from those of the FDIC, Comptroller, etc.? If the FCA had already had such powers, how much difference would that have made to recent FCS

performance?

A. Two major differences between the current powers of the FCA and those of the FDIC and Comptroller concern, first, the FCA's involvement in the management of the System (for example, having prior loan policy authority) and, second, the FCA's lack of strong regulatory powers (for example, cease and desist powers and the power to remove officers and members of the board).

8. Does the current system of autonomous local cooperatives have advantages that would be lost if more authority is centralized nationally in the Farm Credit System and Farm Credit Administration?

A. There is a difference between centralizing and empowering the Farm Credit System and doing the same for the Farm Credit Administration. The Farm Credit Administration should be strengthened because an independent regulatory agency is what can protect this system of autonomous, local cooperatives just as strong regulatory agencies have protected small, independent commercial banks. If the Farm Credit Administration had had strong regulatory powers, it is certainly possible that some of the lending practices (for example, lending at the average cost of funds rather than the marginal cost of funds) could have been avoided.

9. How many financially strong borrowers have been leaving the FCS to find less expensive credit elsewhere? How much has this weakened the FCS?

A. Some financially strong borrowers have been leaving the Farm Credit System to find less expensive credit elsewhere because the FCS's interest rates are going up. This is simply the reverse of a trend of the late Seventies when many financially strong borrowers left commercial banks to move to the FCS because at that time FCS interest rates were lower than those of commercial banks. In both cases, the movement weakened the lending institutions from which the flight took place.

10. What is the relationship between the FCS and ag banks in terms of competition, complementarity, and bond holding? How would assistance to the FCS but not ag banks affect that relationship? How do the FCS and ag banks compare in their costs of obtaining money and lending it?

A. The Farm Credit System and agricultural banks compete primarily in the area of production credit. The Federal Land Banks complement agricultural banks today by providing most of the agricultural real estate credit. However, if commercial banks can get access to a long term source of credit they are eager to make long-term real estate loans and to compete with the Farm Credit System in this area as well. Finally, commercial banks do hold Farm Credit System bonds. As mentioned in the response to question 5, the reason banks hold as many of these bonds as they do results from the regulators' allowing banks to hold the System's bonds without limit.

Assistance to the Farm Credit System that was not extended to the borrowers from agricultural banks would both advantage the Farm Credit

System in competition with the agricultural banks and would make the complementary portion of their relationship more difficult because the Farm Credit System is in the process of consolidating its real estate and production loan operations. This consolidation, aided by federal assistance, would be most divisive to the current relationship between the Farm Credit System and agricultural banks because it would make the Farm Credit System a very strong competitor in an area in which banks at present cannot compete: the ability to lend both long-term for real estate and short-term for production.

The Farm Credit System and agricultural banks both fluctuate in their costs of obtaining money and lending it. In the late Seventies, the Farm Credit System was able to obtain and willing to lend money at rates lower than commercial banks. Today, partly because of the problems evident in the Farm Credit System, the Farm Credit System's cost of money on the bond market is now higher than the cost of money to agricultural banks through deposits and other mechanisms, as a general rule.

11. How do the FCS and commercial bank lenders to farmers differ in terms of diversification of loans, sources and costs of funds? What is the relationship of rural banks to larger banks and money centers? Do they make a net transfer of funds out of rural America that is offset by the FCS bringing money center funds back? Have they drawn in funds from larger urban banks such that a series of rural bank failures would derivatively cause significant problems for larger banks?

A. The Farm Credit System was set up, as they note constantly, for the specific purpose of lending to agriculture. As a result, the Farm Credit System is restricted primarily to agricultural loans and secondarily to loans for other items to farmers and agricultural interests. Commercial bank lenders have the option of a somewhat more diversified loan portfolio. However, in many rural areas of the Midwest commercial banks are almost as confined to agriculture and agriculture-related businesses as is the Farm Credit System.

Rural banks do have relationships with larger correspondent banks that bring outside funds into rural areas when the rural banks sell paper to the larger money center institutions. These relationships would hurt larger urban banks if a significant number of rural banks failed over the next several years. Exactly how many and how much of a problem these bank failures would pose for the larger banks has not been precisely determined.

12. In recent years, the FCS has developed a "Project 1995" strategy to become a stronger competitor. How does the proposed legislation fit within that strategy? What are the implications for farmers and other lenders?

A. There is some indication that unless the power of the proposed Capital Corporation contained within H.R. 3792 is severely circumscribed, that the Capital Corporation has the potential of becoming a very powerful, long-term "central entity" such as was proposed in the FCS' "Project 1995" Phase III. If any of the Farm Credit System's newly chartered institutions such as the Capital Corporation or the Farm Credit Corporation of America were to become such a strong "central entity", the implications for the farmer-stockholders is quite problematic because at that point the System stops being the decentralized, cooperative institution that it was created to be. Such a powerful, centralized nonbank bank would also place commercial agricultural banks at a serious competitive disadvantage. If it developed a strong central entity, the System would also retain its tax advantages as a cooperative, its special access to the credit market as a quasi-governmental agency, its consolidated Land Bank and Production Credit Associations and would be able to compete as a huge, central bank holding company against small, decentralized, independent agricultural banks. If the competition were from an interstate bank that had not received federal assistance or had these other special advantages, one could argue that the competition was fair. Competition from such a nonbank bank with federal assistance is certainly not fair.

ABA's response for the Record, p. 54 is as follows:

So far this year, 105 insured commercial banks have failed. This is the most since the Great Depression and more than half of these failed banks were designated as farm banks. Many of the failures have been concentrated in states where over 50% of banks are farm banks. These states are Iowa, Kansas, Minnesota, and Nebraska, which account for 36 percent of this years' commercial bank failures.

There has been some argument attributing the high rate of bank failures in these states to banking regulations that prevent commercial banks from crossing state lines. It is true that in most states encountering financial problems, regulations prevent banks from interstate branching as well as multi-bank holding company expansion.

Iowa and Kansas had 11 failures each so far this year and both have some kind of restrictions on both branching and bank holding company expansion. For example, Iowa — where over 80% of the institutions are agricultural banks — laws restrict branching with geographic limits and some bank holding company expansion is permitted but with restrictions. Iowa prohibits an out-of-state bank holding company from acquiring an interest in a state bank, unless the holding company was registered with the Federal Reserve Board on January 1, 1971. It is clear that there is a correlation between the restrictions and the problems faced by agricultural financial institutions in those states. The issue, however, is causation not correlation. The problems of agricultural banks are deeply rooted in the economy of these areas rather than in bank regulations.

A close analysis of economic data of agricultural states suggests that many banks' financial problems derive from the depressed conditions currently faced by the agricultural economy. During the past four years, farm incomes have been declining due to low commodity prices and an overvalued U.S. dollar. The agricultural economy's downturn has had its greatest impact on Iowa, Kansas, Minnesota and Nebraska. These states depend on export markets for over 20% of their crops, and the overvalued U.S. dollar has closed these markets for the majority of its farmers. On the domestic front, falling commodity prices are at the point where they can no longer cover production expenses, much less the servicing of farmers debt. This reduced income causes a ripple effect that has had an adverse effect on financial institutions that serve the agricultural sector.

In addition, if branching and bank holding company restrictions were a cause of financial stress in these states, then we should have not seen the deterioration of the Farm Credit System (FCS) that occurred during this year. This is because the FCS has no restrictions as to where it can operate and if a bank in the system faces some type of financial problems it may be bailed out by other banks in the system.

Currently, the financial condition of the FCS is at best precarious, and putting aside management problems faced by the system, its financial condition can be attributed to problems faced by its farm borrowers.

In summary, the financial problems faced by commercial banks in states that have some type of restrictions on branching and bank holding company expansion derive primarily from the economic conditions in those areas of the country. Nevertheless, it is possible that providing banks some degree of product diversification and geographic expansion could have lessened the impact currently affecting agricultural banks. Spreading risk means operating in more than one or a few lines of business. When this happens, earnings in one area can cushion the impact of other areas, including agriculture. Spreading risk further by operating in more than one limited geographic area strengthens the equation even more — when one local economy suffers a set back, earnings derived from operations in other communities allow the business process to continue unimpeded.

ABA's response for the Record, p. 75 is as follows:

The ABA's concerns about the proposed Capital Corporation stem from our belief that it is in the national interest to keep separate the short-term and the long-term aspects of Farm Credit System legislation. As stated in our written testimony, the short-term problem facing the Congress involves solvency of the System. The long-term problem concerns the appropriate role for the FCS in agricultural finance in the future. To establish this new Capital Corporation and give it broad powers to pool System resources, warehouse loans, affect loan policies, establish branch offices and not to limit the time period or purposes for this Corporation's existence creates the potential of a very strong central entity for this decentralized cooperative system. ABA believes that such an entity can lead a strong, aggressive federally-assisted FCS into much more direct competition with commercial banks once the current crisis is over. ABA does not believe that a cooperative financial institution with a cooperative's tax benefits, a quasi-governmental agency's privileged access to the credit markets, and Federal assistance to deal with the same agricultural economy commercial banks are facing should be granted this centralized power. The Capital Corporation should be a limited, special purpose entity designed only to address the FCS's current financial problems.

To circumscribe the Capital Corporation's future potential for central power, ABA proposes:

1) a sunset provision for the Capital Corporation;

2) carefully structured legislative authority that targets and

limits the Capital Corporation's activities to addressing the short-term financial problems of the FCS;

3) a requirement that the pooled FCS assets be returned to the financially strong districts from which the resources are taken, once the System returns to financial health;

4) a representative of the commercial banking industry on the Capital Corporation's board, since it is a special purpose corporation that may serve as the conduit for Federal assistance;

5) representation from the FCS districts that will contribute assets to the Capital Corporation on the Capital Corporation's board since they have a great interest in quickly managing the situation and then disbanding the board and returning the pooled funds to the contributing districts;

6) careful attention to the statutory relationships between the proposed Capital Corporation and existing FCS committees and service corporations (i.e., Farm Credit Corporation of America) to guarantee that the Capital Corporation cannot become a much stronger central entity in the future.

The ABA would be pleased to discuss these concerns and proposals with the subcommittee at any time.

Sincerely

J. Denis O'Toole

THE PROBLEMS OF FARM CREDIT

TUESDAY, NOVEMBER 19, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 2:10 p.m., in room 2128, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce, Representatives Vento, Levin, Carper, Shumway, Wortley, Bereuter, McCandless, and Grotberg.

Also present: Representative Leach.

Chairman LaFalce. The Subcommittee on Economic Stabilization will come to order.

Today marks the fourth of our hearings on the problems of farm credit. At our three earlier hearings, we heard testimony from representatives of the administration, the Farm Credit Council, the Farm Credit Administration, commercial banks, and agricultural economists. At today's hearing we will focus on the problems of farm credit as they affect borrowers.

In the 1970's, farmers and lenders watched as farm prices and land values grew rapidly. People who wanted to get started in farming, to buy more land, or to improve their operations found ready lenders at the Farm Credit System and commercial banks.

In the 1980's, farm income has been cut in half in comparison to the late 1970's. In some Grain Belt States, land values have also plummeted by half or more. As the collateral value of their land has eroded, many farmers have had difficulty in obtaining operating loans.

We take as a given that the sharp declines in farm income lie at the root of the farm credit problem. That has been underlined by almost every witness at previous hearings. This hearing will focus on one aspect of that problem: the relationship between farm borrower and lender.

For several years, many lenders practiced forebearance; some converted unpaid interest payments into new loans in the hope that things would soon turn around. This year's big harvest and shrinking exports are undermining the remaining ground for optimism. As we see in the movies, television screens, and newspapers, foreclosures are on the rise.

Farm groups have expressed several concerns about farm credit problems. Regardless of their own financial position, they worry about interest rates and credit availability come planting season. They want their fellow farmers in financial distress to be given a fair shake to restructure their loans. They do not want to see their land values depressed by massive foreclosures and resale.

We are fortunate to have several witnesses today that can provide the perspective of borrowers. Bob Bergland is now the executive vice president of the National Rural Electric Cooperative Association, whose members are major borrowers from the Farm Credit System. As everyone knows, he previously served as Secretary of Agriculture and chairman of the House Agriculture Subcommittee on Credit. We will also hear from Charles Frazier of the National Farmers Organization; Robert Mullins of the National Farmers Union; David Senter of the American Agriculture Movement; and Lloyd Cline of the Agricultural Credit Group of Commodity Producers.

Before we begin, I will ask the ranking minority member, Mr. Shumway, for any statement he might have.

Mr. SHUMWAY. Thank you, Mr. Chairman.

As we begin the fourth in our series of hearings on the issue of agricultural credit, I would like to join you in welcoming our panel of witnesses. Their testimony should offer a unique perspective on the issues confronting the borrowers in the agricultural credit arena.

In past hearings, we have heard the whys and wherefores leading up to the current farm credit crisis. Simply put, all parties played the inflation roulette wheel during the boom times of the 1970's. Farmers constantly expanded their operations. Banks encouraged this expansion by lending the money. Agricultural academics churned out study after study, recommending further expansion of farm operations. And finally, Federal regulators allowed farmers to up the ante of land values on their financial statements.

Unfortunately, the go-go times of the 1970's bottomed out in the early 1980's. Deflation replaced inflation; the dollar rose in relation to other currencies; foreign markets were weakened by global recession; and record production levels surpassed demand for farm products. All of these factors have combined to reduce farmers' incomes, and hence, their ability to repay their loans to their agricultural lenders—either the Farm Credit System or commercial agriculture banks.

The farm sector's ability to absorb losses has reached a critical point. Serious deterioration of land values continue unabated, with a 17-percent decline during the year ending mid-1985. Many farmers are unable to service their debt loans, now approaching and even exceeding 70 percent.

More importantly, the sector's impaired ability to absorb losses has also shifted to its lenders. The Farm Credit System's financial condition has worsened, as it reported third-quarter losses of $522.5 million. Likewise, the commercial agricultural banks' difficulties loom over the landscape.

I recognize the problems confronting the American farmer, such as fewer sources of and the higher price of credit, as well as the overvalued dollar and overproduction which, in turn, have depressed commodity prices. All affect their ability to generate income and to service their debt.

However, this subcommittee must not lose perspective amidst the debate and clamor over the agricultural credit crisis or the financial difficulties of the borrowers and the lenders within that system. We must question the efficacy of the current agriculture economy, its credit system and proposed Federal financial assistance. For example, it is obvious that agriculture is going through transitions. Consumer demands have shifted and, in some cases, have declined. At the same time, economies of scale in agriculture have increased substantially, making larger operations more efficient.

Significantly, it may well be that in the longer run, changes in the broader economic factors—that is, reduction of the Federal deficit and the U.S. dollar—may be more important to and the most effective rehabilitative policy for the American farmer than other proposed remedies.

This is not to say that other short-term actions should be ruled out of the question. However, I believe we must scrutinize all possible options, including the no-cost alternatives, before we ask the American taxpayer to bear the burden.

Thank you, Mr. Chairman.

Chairman **LaFalce**. Thank you very much.

Are there other members of the committee that have comments they would like to make? Then we will go to a former Member of the House of Representatives and a good friend from those days to the present, Bob Bergland, the executive vice president of the National Rural Electric Cooperative Association.

STATEMENT OF HON. ROBERT BERGLAND, EXECUTIVE VICE PRESIDENT AND GENERAL MANAGER, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, AND FORMER SECRETARY OF AGRICULTURE, AND CHAIRMAN, HOUSE AGRICULTURE SUBCOMMITTEE ON CREDIT

Mr. **Bergland**. Thank you very much, Mr. Chairman and members of the committee. I am here today as the general manager of the National Rural Electric Cooperative Association, a national organization of over 1,000 cooperatives in 46 States which supply electricity to more than 25 million people.

I have been on the job since April of last year and have just concluded a round of regional meetings. While the systems serve all kinds of persons in rural places, we have about 2½ million farming families served by rural electric cooperatives. The hardship and distress which we see in this farming business and has been well reported is coming home to roost, even in the electric utility business.

We have a major coal-fired powerplant in western Kansas which opened just 2 years ago that is on the verge of bankruptcy because of the state of the farm economy. There are four other systems which are feeling the consequences of declining farm income. Serious economic problems in the communities served by these systems is backing up into our large utility operations and putting some of our systems in financial jeopardy and so, Mr. Chairman, this farm depression affects all.

This is not an isolated case, it is one which unfortunately can infect the entire economic bloodstream of the United States, and we will all be the losers.

The irony is that farmers this year will harvest probably the biggest crop in history and from that they will reap serious financial hardship.

When I was at USDA, we conducted and published a study on the structure of farming entitled "A Time to Choose." We found then as we see today about 2½ million farms in the United States. Of that number, about 1½ million are small hobby and part-time farms. They are defined as farming families by the Census Bureau because they sell at least $1,000 of produce from the farm. But in the real world, their income is derived from a job in town.

They feel strong about living in that community as long as the job lasts. They are, however, not dependent on farm prices and commodity policy is not their general or their main concern or interest.

Of the million commercial farms in the United States, about a third have no debt. These are persons usually my age or older who started farming 30 or 40 years ago and have over the years accumulated assets and savings and equity partly because of inflation and partly because of savings. While the cash-flows might not be very attractive, these 300,000 to 400,000 commercial farms are not in danger of losing the homestead.

Another third have a debt of modest proportions, and that leaves a third, about 300,000 of our best producers who are in great danger. These are people who have borrowed to buy modern machinery and install modern farming techniques who are operating on a commercial scale who by any economic standard are efficient. The problem is they have no savings, no equity, they haven't been at it long enough and as soon as hard times come, they are the ones who are vulnerable and will be wiped out.

It has been said that these persons are by definition inefficient. That is simply not true. These are high yielders, good managers, and good workers, but they have a debt service caused by the change in farming technologies that cannot be handled and they have no place to turn.

So the question is whether it is important to the United States to do something effectively to save a whole generation of young people.

Pure, straight market economists will argue that this is a time for the market to sort things out. In my judgment, the market in these matters is much too shortsighted. A marketplace can establish prices, but not value, and there are certain long-range social values that need to be taken into account as we debate whether or not it is important to do anything for these 250,000 of our brightest and best young farm and ranching families or not.

I am convinced unless something is done soon to deal with the credit crunch, that we are indeed going to lose a whole generation, and this, I think, would be a serious mistake.

The Federal deficit has doubled during President Reagan's term. As a consequence, we have the strongest dollar in the history of the United States and the highest real interest rates in my memory, and while some find comfort in profit in that fact, it is a tragedy for our farmers and our rural small business.

It is our judgment that the Federal deficit has caused the strong dollar to appreciate by 40 percent over parity, causing the United

States to be noncompetitive in the world marketplace and as a result of that our exports are plunging.

To give the committee some benchmarks from which to judge, in 1970 we had 62 million metric tons of agricultural product shipped from the United States. In 1980, the year of the infamous Russian grain embargo, we had the record all-time high of 164 million metric tons shipped from this country and now that has collapsed to 126 million metric tons and by most accounts continues to fall.

The fact is that farming is so productive that almost half of our productive base is surplus to our own requirements and must be shipped overseas, and therein lies the problem.

The exchange rate question has more to do with farm prices than almost any other single economic factor in today's marketplace. This is a totally new phenomena with which farming families and their business affiliations are simply unfamiliar and unable to cope with, and so we find farm prices put in a tailspin by factors which are totally beyond their control.

I compliment the Congress and the ladies and gentlemen on this committee and your colleagues for attempting to deal with the business of curbing the Federal deficits. Once that is done, some of these other matters can then start to be dealt with in a more effective fashion.

So long as the exchange rate floats and the dollar gains in value, the rest of these remedies are band aids and will not cure the problem. So the question is whether we want to do anything effective to deal with the problems of these young people.

Some argue that we can ignore this and it will simply go away. Mr. Chairman, from 1940 to 1965, 20 million people left the farms of the United States and went someplace else. The largest migration in our society has taken place in our country in my lifetime. During that tremendous dislocation, which was brought on by a number of events and factors, we moved our rural poverty to urban places and in the middle 1960's, it exploded, much of this had its roots in rural poverty.

We simply ignored the question. We said to these people who were displaced by factors beyond their control, go someplace else, and so we paid for it in the mid-1960's. We will pay for it again if we don't help these persons wanting to stay in that community and contribute to the economic and general welfare of the United States.

I am afraid we are going to pay for it later in some more unpleasant fashion, it may be in food stamps or direct relief in some city agency and that is not a remedy.

So this committee is in a position to gather data and information to deal with the question of whether or not the Government should interfere in markets.

If the marketplaces are left to seek their own values, we are going to find the American rural economy torn to shreds because of the social factors which are not taken into account in establishing a price, and so intervention in the marketplace is necessary from time to time, and in this credit situation intervention is again the order of the day.

We in rural electrics do not have a specific program to bring to this committee, Mr. Chairman, in regard to the farm credit matters.

My colleagues on this panel are more qualified to deal with that than I am. If there is anything that we can do to help you and your colleagues in dealing with this matter, we will do our best.

Thank you, sir.

[The prepared statement of Mr. Bergland follows:]

STATEMENT OF NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
THE HOUSE COMMITTEE ON BANKING FINANCE AND URBAN AFFAIRS
SUB COMMITTEE ON ECONOMIC STABILIZATION
TUESDAY, NOVEMBER 19, 1985

Mr. Chairman, I am Bob Bergland, Executive Vice President and General Manager of the National Rural Electric Cooperative Association, the national association of over 1000 rural cooperatives which supply central station electricity to more than 25 million people in 46 states.

I appreciate the opportunity to appear before this committee today to discuss the serious credit crisis ravaging rural America -- a crisis of farmers, a crisis of small towns, schools, churches and businesses, and a personal crisis and tragedy for individual men, women and children. The credit crisis, in my judgment can be overcome. But the loss of confidence connected with the loss of family farms and businesses is much more difficult to overcome.

I have been on the job at NRECA since April of 1984. As a former member of the House Agriculture Committee and as Secretary of Agriculture I had numerous opportunities to travel to the far reaches of America to discuss farm policy. But in the 19 months I have held this position I have had an "on site" seminar of the tremendous problems engulfing rural America.

We have just completed a series of 10 regional meetings with representatives of rural electric systems from all 46 states in which we have members. The news is all the same. The news is very bad. I fear that the farm crisis will get worse before it gets better. Some say prospects of enacting legislation that will save very many of the half-million farmers reportedly in various stages of financial trouble are bleak.

It looks as if farmers will reap a bumper crop and low prices, the all too familiar story. Farmers will bin huge tonnages of soybeans, corn and other grains. But an estimated 214,000 of them won't make enough to cover expenses, family living needs and service the debts they've piled up. Last year net farm income barely paid the interest on the total farm debt.

Our federal deficit has doubled during Ronald Reagan's watch, as he likes to term his presidency. As a consequence, we have the strongest dollar in the history of the United States, and the highest real interest rates in memory. While some find profit and comfort in that fact, it is a tragedy for our farmers and for our rural small business people. The strong dollar has imposed a 40% tax on all exports, causing a sharp drop in farm commodity prices.

Our farm exports increased dramatically in the 1970s from 62 million metric tons in 1970 to a high of 164 million metric tons in 1980, but have now collapsed to an estimated 126 million metric tons in 1985.

The economic answers to the farm problem are not nearly as complex as the politics of trying to get them enacted into a farm program and signed into law.

Is there any gain to us as a nation or society, when farm families are forced to leave the land and move to a distant city in search of work? Have we solved the problem or have we merely shifted it to a new locale?

In reality there is no escape. We pay for it, whether it is through farm programs or through food stamps and welfare payments to those who can't find jobs.

You and I know the farm crisis is not a problem from which we can just walk away. The preservations and strengthening of the nation's rural communities are important to the entire nation. They're our concern. When NRECA members, the rural electric systems, have to disconnect the meter on farm after farm, that's trouble.

I have often asked the question: What is the proper role of our government when a problem interfering with the lives of its people exists? Should we compare this rural crisis with the Chrysler and New York City crises of just a few years ago? I believe the answer is yes. There certainly is a precedent for a partnership of the people and their government. This, I think, is the time for the Congress to act before the situation deteriorates even further. I have no specific proposals to offer but ask you to listen to representatives of the agriculture associations, organizations representing our financial institutions, and individuals who have worked closely on this issue and are making recommendations to the Congress. I have no envy for the responsibility of Congress, whose job is to make the tough decisions necessary to resolve the problem.

I took the job as General Manager of NRECA because I believe the mission of the organization and its members is of the highest importance to this nation. I plan to stay the course and expect to be on this job working with you and the Executive Branch to protect and improve rural America.

Mr. Chairman, this completes my testimony. I will be happy to respond to any questions of comments of you or the members of the committee.

Chairman **LaFalce**. Thank you very, very much for that excellent presentation. You would know and perhaps the others know that when those bells ring we have to go on over to vote and at 2:22 we had the first ringing, which indicated we had 15 minutes. We now have 10 minutes to get over for a vote.

There will be up to three votes, I am going to recess until approximately a quarter to 3.

Do any of you gentleman have time constraints?

Mr. **Bergland**. No, sir; I can be here.

Chairman **LaFalce**. Fine. I am sorry to do this to you, but we have to conduct our hearings very often when the House is in session.

The subcommittee will stand in recess until approximately 2:45. Thank you.

[Recess.]

Chairman **LaFalce**. The hearing will resume. We will resume our hearings and our next witness will be Mr. Charles Frazier, the director of the Washington office of the National Farmers Organization.

STATEMENT OF CHARLES L. FRAZIER, DIRECTOR, WASHINGTON OFFICE OF THE NATIONAL FARMERS ORGANIZATION

Mr. **Frazier**. Thank you, Mr. Chairman and members of the committee.

I appreciate the opportunity to appear before you briefly today and hope that we may be helpful. If my statement may be made part of the record in its entirety I will just touch on the highlights.

Chairman **LaFalce**. We will put the entire statement of every member of the panel in the record.

Mr. **Frazier**. Thank you, sir.

I will not undertake to repeat statements. Mr. Bergland did a fine job of summarizing the extent of our difficulty in the country. I would emphasize that it is the rapidity with which these circumstances have developed over the last 12 months that have alarmed the leadership of my organization, and, for that matter, we are seriously concerned that legislation may be forthcoming from the Congress.

I find among my members when we are visiting about this whole thing that they do not wish for a bailout of the system without due attention to the income and the cash-flow of individual owner-operators out there on the farms and ranches.

I realize that is not necessarily a prime consideration for your committee, but I will hope that you would keep this in mind as you work with Mr. de la Garza, Mr. Jones, and others on this legislation.

We have to have an improvement in farm income or the whole exercise of saving the lending institutions will fail, and we will be back before you again a year or two down the road.

The second area of concern is that we believe there are three or four steps that should be taken, either simultaneously or in sequence, but we think it would be a mistake to bail out one phase of farm lending without some due attention to the FmHA and the private banks.

I do not come before you with a formula or a system that would promise no-fail results, but we would like to see this whole matter handled in the Congress in a way that will not result in changing the balance of business between the Farm Credit System and the private banks out there in the country.

There is another aspect involved in the final action to be taken in this whole field. We would seriously hope that in the leasing or sale of land that has or will come into possession of one of these agencies that every effort must be made to place this land with individual mid-range owner-operators.

We do not want more tax-loss operators or more foreign investors in our farm communities. Now, again, this is not something that is easily formulated or written in terms of a banking bill, but it is the value involved, as Mr. Bergland highlighted a moment ago, that seriously concerns our members.

We find in too many farming communities today it is the attitude of some of the managers, some of the bank types and others to look for investors, people who may have sufficient bankroll behind them, to take up some of this land, some of the credit burden.

We are specifically concerned that any efforts coming out of this Congress now be directed toward sustaining the individual owner-operator style of farming that is the backbone of our agriculture in this country.

To summarize very quickly, we can see a continuing need for increased net farm income for revitalization of these credit agencies and for some occasion that the family farm system will survive this whole current catastrophe that we are going through out in the country.

If I might add a personal note, I come from north Missouri, a farming community with three or four little towns there. We have already lost one bank about a year and a half ago, another bank is reported to be in trouble; it is simply devastating to watch the consequences when one of the PCA's dries up and stops advancing loans. When the independent bank changes hands, going into management under FDIC and promptly separates cash accounts from mortgage banking, leaves all the producers no matter their status with respect to their own loans high and dry without a source of continuing credit the community simply goes into shock.

I can't emphasize enough that this is not an isolated incident. I was with our board of directors last week in the Midwest. We are facing dire consequences throughout the whole grain belt and the livestock areas in that part of this country, if we cannot reorganize this credit arrangement. We would hope to be of help to you, Mr. Chairman, as you proceed with this bill.

Thank you.

[The prepared statement of Mr. Frazier follows:]

NATIONAL
FARMERS
ORGANIZATION

Subcommittee on Economic Stabilization
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

STATEMENT
CHARLES L. FRAZIER
National Farmers Organization
November 19, 1985

FARM CREDIT

Mr. Chairman and members of the Subcommittee, first let us thank you for arranging this hearing and providing time for us to appear before you today. Mr. DeVon Woodland, our National President, farmer and rancher from Blackfoot, Idaho, has asked me to bring you his personal greetings and emphasize our appreciation of your interest in the farm depression in which we are now entangled. We are an organization of farmers and ranchers committed primarily to bargaining for better prices on our products. The fifth year of depressed prices and severe financial trouble will soon confront us.

We are advised that about $50 billion of the $212 billion in total agricultural debt outstanding today cannot be serviced through 1985 and 1986 unless we substantially increase the cash flow for our farm producers. We are told that the Farmers Home Administration holds roughly $32 billion of that total debt and $6 to $7 billion of it is twelve months or more past due.

The Federal Farm Credit Banks Funding Corporation has just publicly acknowledged losses totaling $426 million in the first nine months of this year. Perhaps it is even more alarming to note that loans classified in the non-accrual status increased from $2 billion as of June 30 of this year to $3.5 billion by the end of September. Those numbers correlate with the rapid increase in reported bankruptcies and close-outs coming to us through our own channels.

We understand that, of the 56 banks that failed before July 1 this year, at least half of them were heavily involved with agricultural loans. We are also advised that about one half of the banks on the FDIC "Watch List" are agricultural banks, i.e., those with twenty-five percent or more of their loans that are farm oriented. Agricultural credit from this source annually amounts to $40 to $50 billion of the $212 billion mentioned earlier.

Nearly a year ago we noted the Federal Reserve Board's report that farmers and ranchers had lost $250 billion in asset values over the previous four years. We called for expansion of the FmHA direct loan program and an interest buy-down for reliable producers in the mid-range size of operation. We also urged a "stop" order on FmHA foreclosures for a reasonable period of time.

As we look back over this year, we are convinced of the validity of those viewpoints. The Congress did respond with action but we were frustrated by the Administration's veto of the legislation. The administrators of the FmHA program may have let up somewhat on foreclosure actions, but the feeling running throughout farm communities has moved from one of dissatisfaction and concern to an attitude of despair. Many people have become so discouraged that they have grown very quiet. They come to our meetings to talk about bargaining, prices, interest rates and related concerns, but they no longer express confidence that Washington is going to help.

This is the severe challenge facing you today. Can you help? Is the Congress going to move with enlightened legislation or are we to be continually confronted with the stand-off between the Congress and the Administration such as we have experienced over the last twelve to eighteen months? We urge you to move decisively, based on your own good judgment, and let the Executive Branch be responsible for its own decisions.

GUIDELINES FOR ACTION

The Farm Credit System. Don't bail out the investors and financial institutions unless you are going to strengthen the cash flow for the individual owner-operators in the mid-range of farming. Failure to take this precaution will only mean that you must repeat the action in the future until we can afford to pay our debts.

We are flexible in our attitudes on what should be done on farm income. A farm bill has passed in the House. It is inadequate but considering the time remaining for action in this session there is little you can do in that area at the moment.

However, we do beg your indulgence and support on any credit bill that may now originate in the House Agriculture Committee.

Chairman Ed Jones of the Subcommittee on Conservation, Credit and Rural Development is expected to bring out legislation that would stabilize the programs of the Farm Credit System. Some features of that bill probably will recognize the problems in agricultural banks. We hope you will regard them favorably.

Form of Assistance. In our testimony before Mr. Jones' subcommittee on October 31 we stated, "In order to meet the obvious urgency of aiding the whole Farm Credit System, action must be taken soon. If you start with that assumption, there probably will not be time to establish a modern Reconstruction Finance Corporation to serve as a central banking agency for all the farm financial institutions. Yet, it would be wrong to refinance the System and extend no relief to the independent banks who carry about $40 billion of farm operating debt in addition to their land loans.

"We suggest that it may be best to report a two-part bill. Deal with the Farm Credit System by underwriting bonds in the money market and extend an improved and enlarged guaranteed loan opportunity through the FmHA.

"It probably will be necessary to move with a combination of stronger direct loan action and a modified guaranteed loan arrangement containing an interest buy-down feature. It is not unreasonable to ask the bank to reduce interest rates by two percent while offering another matching two percent cut from federal funds to encourage private banks to carry clearly qualified farm borrowers who can survive with such an arrangement, but who are otherwise going under.

"A parallel action should authorize and direct FmHA to assume some land loans now carried by the banks where the producer is well qualified and the bank will discount the loan rather than push a foreclosure and sale of the land at current price levels. In this case the producer must be relieved of the loan obligation proportionate to the discount."

Producer Interests. We also recommended that certain priorities be observed in the administration of any reorganized credit arrangement resulting from new legislation. We would appreciate your support along these lines:

(1) Regardless of whether a borrower is in the Farm Credit System, the FmHA group, or is serviced by private banks utilizing

the guaranteed loan feature, first consideration should be given to refinancing and permitting a present borrower to stay on the land if the family is capable, hardworking and making an effort to meet financial obligations.

(2) In the leasing or sale of land that has or will come into possession of one of the agencies, every effort must be made to place that land with an individual mid-range owner-operator. We do not want more tax loss operators and foreign investors in farming.

(3) A reasonable balance among agencies and institutions as to the availability of credit should be maintained. In other words, this crisis should not be permitted to change substantially the proportion of farm credit carried by the Farm Credit System, the FmHA and private banks if such a shift can be avoided.

To summarize, in this brief presentation we have concentrated on the need for increased net farm income, revitalization of the credit agencies serving farmers and what may be done legislatively to correct some grievous policy directions of the past. Perhaps it would also be well to think of the possibility of positive accomplishment that may come out of this price and credit crisis. We have nearly lost the family farm system that has proven to be so successful in the past and served as an important part of our heritage throughout our national history.

In the placement of properties they now own or those coming into their possession in the near future, the credit agencies would do well to search for young farm families capable of making a new start in farming. To accomplish such a goal, local leaders in the credit institutions will have to take the initiative. Many of the judgments and decisions will be subjective in nature and may involve some risk. Nevertheless, we harbor the hope that this farm economy can be turned around.

When that occurs, we would like to think that those who will control the land, the small business houses and the future of community affairs in Rural America will be people with long-standing interests in those communities. We will have little faith in a total system based upon absentee ownership and a large floating tenant population whose commitments can only be of a short term nature. Most of our ancestors came here to get away from such a system. As an organization, we resent that old system following us here and now destroying the very communities that are such an important part of America. We built them -- we want to keep them -- and we think it is in the country's interest to do so.

Mr. Chairman, again we thank you and the members of this Committee for the opportunity to present our views. Your interest is timely and certainly it is appreciated. If we may be of service in consideration of specific legislation please call on us.

Chairman LAFALCE. Thank you. Our next witness is Robert Mullins, director of legislative services for the National Farmers Union.

STATEMENT OF ROBERT J. MULLINS, DIRECTOR OF LEGISLATIVE SERVICES FOR THE NATIONAL FARMERS UNION

Mr. MULLINS. Thank you, Mr. Chairman.

I am Robert Mullins, legislative director for the National Farmers Union, a general farm organization representing approximately 300,000 farm and ranch families across the United States.

Mr. Chairman, in our opinion it is very appropriate for this Subcommittee on Economic Stabilization to be holding these hearings, because we sincerely believe in the final analysis that the stability of our entire economic system depends on the economic stability of the agricultural sector.

Mr. Chairman, you alluded to it earlier in your opening remarks, but I think one important point has to be made at the outset. What we have in American agriculture today is not a credit crisis per se but an income crisis. If farmers and ranchers had the ability to repay their obligations, the lending institutions would not be faced with the problems they have today.

That we are faced with an economic crisis in the rural community should come as no surprise to any Member of this Congress as they have tackled their responsibilities over the last few months in trying to rewrite the 1985 farm bill.

What is frightening is the rate at which the situation continues to deteriorate and the fact that no one now denies it has reached crisis proportions.

In stark terms, the reports have verified huge equity losses by farmers which impacts on rural banks and other farm credit agencies who now find themselves in financial trouble and joining farmers in facing possible bankruptcy. We are all aware of the current financial situation of the Farm Credit System. Sooner or later this Congress will be called on to assist the system in order for it to remain solvent.

Similarly, the Congress will be called on to bolster the lending programs of the Farmers Home Administration. On the commercial side of farm credit, about 400 of the 1,000 banks now on the FDIC's trouble list are agricultural banks. So far in 1985, 50 of the bank failures in this country have been agricultural banks.

The important part in all of this to realize, Mr. Chairman, is what is happening in rural America—not only to our farmers and ranchers, but to our rural communities with their small business schools and churches.

The entire economic and social structure of rural America is facing collapse under current conditions. Now the economic and social consequences of the depression in rural America have infected the financial community and threatens our entire economy.

We have already lost a quarter of a million off-farm jobs, industrial and service jobs, because farmers can no longer afford to purchase the equipment and input items that are made by those workers.

Just a few quick observations about the economic conditions that are resulting in this inability to repay farm debt.

Prices received by farmers for most commodities are running 20 to 25 percent below a year ago, and prices are forecast to be even lower in 1986. Net farm income for 1985 is forecast between $23 and $27 billion, compared to $34½ billion in 1984. Farmers' return on equity will be negative for the fifth consecutive year in 1985, and may run a minus 20 percent or more; and land values are off in many Midwestern States by about 20 percent from a year ago and only about half of what they were 5 years ago.

In recent weeks, public attention has been focused on the financial situation facing the Farm Credit System. Our farm financial stress is not limited to the Farm Credit System.

The question that then comes to mind is, who holds this farm debt? The Farm Credit System holds about 31 or close to 32 percent of total farm debt, while commercial banks hold about 24 percent, individuals 22 percent, Farmers Home Administration about 12 percent, life insurance companies 6 percent, the Commodity Credit Corporation about 4 percent.

Country banks, the ones most of our members deal with, are facing serious problems. Seven of those banks failed in 1983, 32 of them failed in 1984, and 50 of them have failed so far in 1985.

On the private side, in March 1985, nonaccrual farm production loans at all commercial banks totaled $1.7 billion, with another $1 billion in nonperforming loans, and $1.3 billion in loans past due 30 to 89 days.

As we all know, the Farmers Home Administration is the lender of last resort. As a result of the economic troubles in agriculture over the past several years, the number of these loans have increased from about $1½ million in 1979 to almost $2 million in late 1984, and on those loans the delinquency rate is now running about 30 percent.

Mr. Chairman, we suggest that the economic impact of this continuing financial crisis and the implications for the entire economy have been well documented by the Wharton Econometrics Forecasting Association, when they issued a report in July 1985 entitled, "Economy-wide Impacts of Agricultural Sector Loan Losses." I won't take the time, but I would direct the committee's attention to page 9 of our prepared text and review what Wharton Econometrics say would be the result of these continued——

Chairman LAFALCE. We had Wharton testify before us.

Mr. MULLINS. Yes, thank you.

Mr. Chairman, we believe that the Congress is going to have to take emergency action this year. Such emergency action taken by this Congress, by the lending institutions or by the Farmers Home Administration will have to address, one, the needs of individual farmers to meet their debt obligations and secure financing for next year's operations and, two, the institutional needs of those lending institutions.

To address the needs of individual farmers facing immediate debt payments and obtaining operating capital for next year, the following measures need to be implemented.

One, borrowers in all three sectors, private, cooperative, and the Farmers Home Administration, must be permitted to restructure their debt commensurate with their ability to repay.

Two, Farmers Home Administration borrowers should be permitted on a case-by-case basis to defer payments on principal and interest.

Three, Government guaranteed operating loans should be made available to borrowers through private lenders and to those producers who do not qualify for Farmers Home Administration loans.

Four, the Farmers Home Administration should be required to make direct operating loans to qualifying borrowers, whether new or current.

Finally, loans and services provided through the Small Business Administration must continue to be available to farmers.

Mr. Chairman, for those lending institutions serving agriculture, the following actions need to be taken.

One, where necessary agricultural banks should be assured of obtaining adequate loan funds at reasonable costs through the Federal Reserve System.

Two, Congress must increase the Farmers Home Administration's appropriations for low-interest, direct operating loans.

Three, Congress also must provide direct appropriations for interest rate buy-downs.

Four, we are recommending that a federally chartered corporation should be established to assume temporary control of farm and ranchland which has been foreclosed or forfeited to any lending institution.

Mr. Chairman, we recognize that we are in a tight budget situation, but we think that the overall problem is of such magnitude that it impacts not only on agriculture and our rural communities but is getting to the point where it is going to impact on the entire economy, jobs and further budgetary outlays as this condition continues to worsen.

We appreciate the opportunity to be here and hope to work with you and the other Members of Congress in attempting to curb this continuing financial crisis.

Thank you.

Chairman LAFALCE. Thank you, Mr. Mullins.

[The prepared statement of Mr. Mullins follows:]

NATIONAL
FARMERS
UNION

STATEMENT OF

ROBERT J. MULLINS
DIRECTOR OF LEGISLATIVE SERVICES
NATIONAL FARMERS UNION

PRESENTED TO THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION
COMMITTEE ON BANKING, FINANCE &
URBAN AFFAIRS

CONCERNING

"THE FARM CREDIT CRISIS"

WASHINGTON, D.C.
NOVEMBER 19, 1985

Mr. Chairman and Members of the Subcommittee:

My name is Robert J. Mullins. I am the Director of Legislative Services for the National Farmers Union, a general farm organization representing the views and interests of some 300,000 farm and ranch families throughout the United States. On behalf of our membership and millions of other farm families and rural businesses who depend upon the agricultural sector of our economy for their livelihoods, I appreciate the opportunity to appear before this Subcommittee today.

It is very appropriate, in our opinion, for the Subcommittee on Economic Stabilization to be holding these hearings because we believe, in the final analysis, that the stability of our entire economic system depends on the economic stability of our agricultural sector.

Let me make an important point at the outset -- What we have in American agriculture today is not a credit crisis, per se -- What we have is an INCOME CRISIS!

If farmers and ranchers were getting a decent price for their wheat and corn and cattle and cotton, there would be no crisis for farmers or their lending institutions. There would be no problem with plummeting land values leading to collateral problems, no problem with private lenders foreclosing on farmers, and no problems with government or cooperative lending institutions.

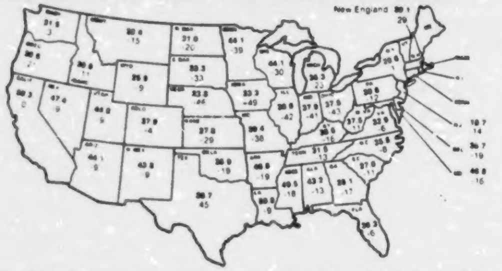
600 Maryland Avenue S.W. • Suite 202 • Washington, D.C. 20024 • Phone (202) 554-1600

That we are faced with an economic crisis in the rural economy should come as a surprise to no Member of this Committee, no Member of Congress nor any other watchful American. Many members of this Committee have been well aware of the mounting economic problems of America's farmers as you exercise your responsibility as Members of the Banking Committee responsible for the security of America's financial institutions.

What is frightening is the rate at which the situation continues to deteriorate and the fact that no one now denies that it has reached crisis proportions. That has been well documented by reports from the U.S. Department of Agriculture, the Federal Reserve Board and a host of private analysts and surveys. In stark terms, those reports verify huge equity losses by farmers (Chart #1) and the impact this is having on a growing number of rural banks and other farm credit agencies who now find themselves in financial trouble and joining farmers in facing possible bankruptcy.

We are all aware of the current financial situation of the Farm Credit System. Sooner or later this Congress will be called on to assist the System in order for it to remain solvent. Similarly, the Congress will be called on to bolster the lending programs of the Farmers Home Administration. On the commercial side of farm credit, about 400 of the 1,000 banks now on the FDIC's "troubled list" are agricultural banks. Fifty (50) "agricultural banks" have failed so far in 1985.

Chart #1



Key 30.6 Percentage change in average value of farm real estate per acre from 1977-1981
-20 Percentage change in average value of farm real estate per acre from 1981-1985

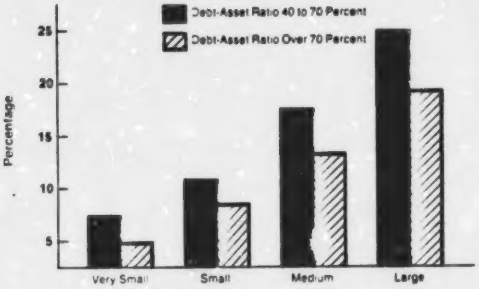
Based on indices of average value per acre

LAND VALUES -- THE BASIC COLLATERAL FOR LOANS -- HAVE DECLINED IN MOST STATES SINCE 1981 1/

BEST COPY AVAILABLE

A recent survey by USDA indicates that as many as 250,000 American farms may have serious financial leverage problems and as many as 145,000 may have extreme financial leverage problems. According to the Farm Journal's March 1985 issue, nearly 42 percent of the farmers in an 11-state region of the Midwest are experiencing moderate to severe financial stress and that over 20 percent of the farmers in that region face the likelihood of being forced out of farming by the end of this year (Chart #2).

Chart #2



(Size of farms -- 1984*)

MEDIUM-SIZED AND LARGE FARMS
ARE THE MOST FINANCIALLY STRESSED 2/

*Farm size based on gross sales of products. Very small: $1,000 - $9,999; Small: $10,000 - $39,999; Medium-sized: $40,000 - $199,999; Large: $200,000 and over.

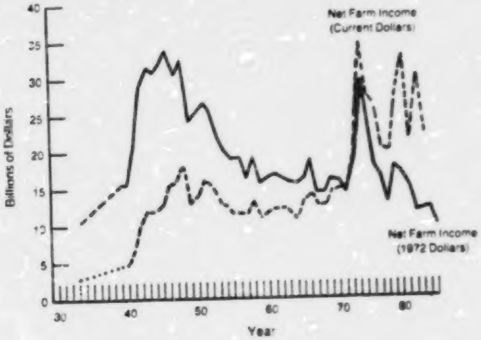
Many of us had hopes earlier this year that the Congress would address the long-term problem in American agriculture -- adequate income -- in a positive and responsible manner as you undertook the task of writing the 1985 Farm Bill. It is now over eight months since the Committees began their work, and we have yet to have a bill. Although the legislative process has, as of yet, not been completed we do know, based on actions taken so far, that the final product will simply be inadequate.

I recognize the fact that budget hysteria has swept Capitol Hill, and the deliberations over the Farm Bill got caught up in that wave, but I will remind this Committee and the Congress that a good farm bill doesn't necessarily mean an expensive farm bill. If it were the case of simply throwing money at the problem, this Administration would go down in history as the greatest financial benefactor of the American farmer -- ever; this Administration has spent more money on farm programs in the past four years than any other Administration in history, and yet we have to go back to the 1930s to find economic conditions in agriculture in worse shape.

What I am saying is that farm programs do not have to be costly to be effective -- they only need be managed efficiently using the tools Congress has provided over the years to balance supply and demand of farm products.

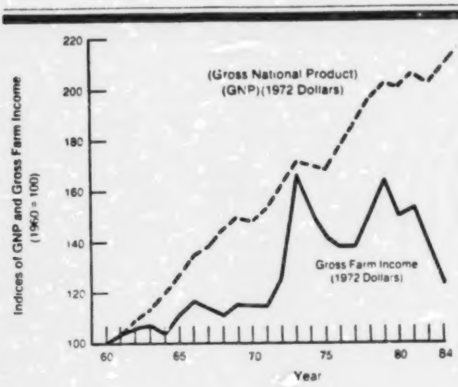
Quite frankly, this Administration has spent more and done less because it has simply mismanaged the programs (Chart #s 3 and 4).

Chart #3



REAL FARM INCOME WHIPSAWED DURING THE PAST DECADE, AND IS NOW AT THE LOWEST POINT SINCE THE DEPRESSION 3/

Chart #4



REAL GROWTH IN FARM INCOME HAS NOT KEPT
PACE WITH GROSS NATIONAL PRODUCT 4/

The important point in all of this is to realize what is happening in rural America, not only to our farmers and ranchers, but to our rural communities with their small businesses, schools and churches. The entire economic and social structure of rural America is facing collapse under current conditions. Now the economic and social consequences of the depression in rural America have infected the financial community and threaten our entire economy. We have already lost a quarter-of-a-million off-farm jobs (industrial and service jobs) because farmers can no longer purchase the equipment and input items that are made by those laborers.

More and more, others outside the agricultural community are coming to recognize the importance of agriculture to our entire economic system. On May 7, 1985, the Executive Committee of the AFL-CIO issued a statement on farm policy, "Farmers and Workers - Some Common Concerns." In part, that statement said:

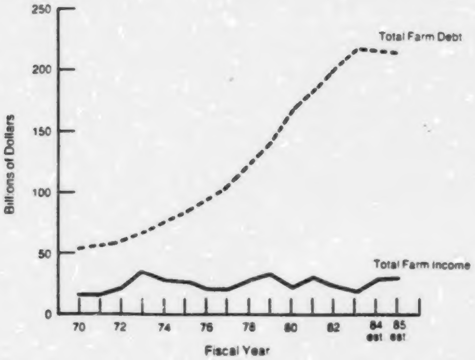
> "We are convinced that a healthy agricultural system based on strong, prosperous family farms is essential to America's economic and social well-being..."

Here are a few observations about the true economic conditions facing today's agriculture and its lending institutions:

- Prices received by farmers for most major commodities are running 20 to 25 percent below a year ago. Prices are forecast to be even lower in 1986.
- Net farm income for 1985 is forecast between $23 and $27 billion, compared to $34.5 billion in 1984.
- Farmers' return on equity will be negative for the fifth consecutive year in 1985 and may run a minus 20 percent or more.
- Exports of farm commodities are forecast at $32 billion, nearly 16 percent below 1984. Volume is expected to be off 10 percent from a year earlier. No upturn in either export value or volume is expected for 1986.
- Land values are off in many Midwestern states by 20 percent from the previous year and are only about half of what they were five years ago.

With these conditions facing agriculture, two questions arise: one, how do farmers pay off debts already incurred; and, two, how do they obtain the necessary operating capital to put in a crop and harvest it next year? What lending institution -- private, cooperative or federal -- could realistically provide credit to farmers without hope that they could earn enough to repay their loans?

Chart #5



FARM DEBT HAS REACHED STRESSFUL LEVELS IN THE 1980s 5/

In recent weeks, public attention has been focused on the financial situation facing the Farm Credit System; however, financial stress is not limited to the Farm Credit System.

The situation of the federal Farm Credit System is a matter of serious concern to be sure.

About $11.1 billion on its $80 billion in loans is now considered uncollectable. Rescue efforts by other segments of the system have been necessary at the Intermediate Credit Banks of Spokane and Omaha. Two other systems may need help shortly.

If farm prices and income continue their collapse, reserves of the system could be depleted at a dangerous rate.

The financial stress in the agricultural sector, however, has been felt equally by lenders other than the Farm Credit System alone.

Who holds the farm debt?

The Farm Credit System holds 31.9% of the total farm debt, while commercial banks hold 23.4%, individuals 22.6%, Farmers Home Administration 12.1%, life insurance companies 5.8% and the Commodity Credit Corporation 4.2%.

Country banks with 25% or more of their loan portfolios in agricultural loans are considered "agricultural banks." There are about 5,000 such banks.

Seven agricultural banks failed in 1983, 32 in 1984 and 50 so far in 1985.

About 400 of the 1,000 banks now on the FDIC's "troubled list" are agricultural banks.

At the beginning of 1985, the Federal Reserve indicated that 102 agricultural banks had nonperforming loans exceeding their total capital. This compared with 42 banks in such a situation a year earlier. At 240 banks, the combined sum of past due and nonperforming loans exceeded total capital, up from 133 banks a year earlier.

In March 1985, nonaccrual farm production loans at all commercial banks totaled $1.7 billion, with another $1 billion in nonperforming loans, and $1.3 billion in loans past due 30 to 89 days. These poorperforming or nonperforming loans constituted about 10% of the total of all farm production loans. During 1984, commercial banks charged off about $900 million in loans.

The Farmers Home Administration (FmHA) is an agency of the U.S. Department of Agriculture created for the purpose of serving as a last resort source of credit for those farmers who cannot obtain loan funds elsewhere.

As a result of the troubles in agriculture the past several years, the number of last resort loans has increased from 1.5 million in 1979 to almost 2 million in late 1984. About 270,000 active borrowers hold these loans.

The delinquency rate on these loans now is running about 30%.

FmHA has about $28.1 billion in outstanding farm loans and the bulk of these are direct or insured loans. The agency has been seeking to shift from direct loans to guaranteed loans and has made some progress but in 1984 the direct loans still were running about three times larger than the guaranteed loans in volume.

The Reagan Administration in the fiscal 1986 budget message proposed to terminate the farm ownership and emergency disaster loan programs, but Congress did not accept that recommendation. Such a step would have left some farm operators, unable to get credit from commercial sources, with no place to go.

Who gets hurt by a failure to restore fair farm income?

The damages will be widely shared in the national economy if action is not forthcoming to restore farm prices and income at the same time that measures are taken to protect the Farm Credit System and other agricultural lenders.

True, the immediate losers will be America's farmers who will lose their farms and the equity which they had built up. If the Farm Credit System should collapse, farmers would lose their $5 billion in equity in the system.

The Farm Credit Banks have some $62 billion in bonds outstanding. About 15% of the system's loans are nonperforming. The proportion could become larger.

Investors would shoulder the burden if the system defaults on its obligations. The losers would include individual investors, commercial banks, insurance companies, states and municipalities, pension funds, money-market funds, foreign banks and foreign governments.

Even if there is a federal bailout of the Farm Credit System, investors could sustain some loss and might lose confidence in the value of future investments in Farm Credit bonds. This in turn would increase the cost of capital raised for Farm Credit loans. Unless meaningful steps are taken to bolster farm income, further crises and further bailouts could become necessary and farmers, investors and taxpayers will suffer.

The Wharton Econometric Forecasting Associates in a July 1985 study entitled, "Economy-wide Impacts of Agricultural Sector Loan Losses," evaluated four agricultural loan loss scenarios for 1986. The report studied a range of loan losses between $10 billion and $50 billion and assumed that the most likely occurrence would be loan losses in the range of $20 to $25 billion.

Farm loan losses of such a magnitude would, according to Wharton, have these impacts on the U.S. economy:

* Higher short-term interest rates, by perhaps 75 and 125 basis points.

* Higher interest rate risk premiums in agriculture, with agricultural sector rates about 40 to 50 basis points above other private rates.

The economic effects on the national economy over the period of 1985-1993 would be:

* Higher interest rates would retard investment spending.

* Business investment would be reduced by $24 to $38 billion.

* Housing starts would be reduced by 115,000 to 189,000 units.

* Real Gross National Product would drop by $31 to $49 billion.

* Job losses would be in the range of 175,000 to 275,000 jobs.

* Personal disposable income would drop by $12 to $18 billion.

* The U.S. federal debt would increase by $14 to $22 billion.

The Wharton study says "these negative macroeconomic effects of agricultural loan sector losses could be reduced substantially, if not eliminated entirely, if preemptive actions are taken...A comprehensive approach would ensure that the 1985 farm bill did not sharply curtail farmers' ability to meet their debt service obligations over the next several years."

Now having detailed the magnitude of the problem facing America's farmers and ranchers, we find ourselves faced with another immediate crisis; farmers will be searching for a way to hang on for one more year, trying to make their payments on last year's loans and arrange financing for next year's crops. As I have stated before, the long-term solution to this problem is adequate income so farmers can pay their obligations. However, in the meantime emergency action must be taken to allow farmers the opportunity to stay in business.

Such emergency action taken by the Congress, the lending institutions, or the FmHA will have to address: 1) the needs of individual farmers to meet their debt obligations and secure financing for next year's operations; and 2) the institutional needs of the lending agencies.

To address the needs of individual farmers facing immediate note payments and obtaining operating capital, the following measures need to be implemented:

1. Borrowers in all three sectors -- private, cooperative, and FmHA -- must be permitted to restructure their debt allowing for repaying of principal and interest over an extended period of time at levels commensurate with their income.

2. Farmers Home Administration borrowers should be permitted, on a case-by-case basis, to defer payments on principal and interest.

3. Government guaranteed operating loans should be made available to borrowers through private lenders and to those producers who do not qualify for FmHA loans.

4. FmHA should be required to make direct operating loans to qualifying borrowers, whether new or current.

5. The Approved Lenders Program should be expanded to allow private lenders to use FmHA programs for their borrowers.

6. Loans and service provided through the Small Business Administration must continue to be available to farmers.

For those lending institutions serving agriculture, the following actions need to be taken:

1. Where necessary, agricultural banks should be assured of obtaining adequate loan funds at reasonable costs through the Federal Reserve System.

2. Congress must increase the Farmers Home Administration's appropriations for low interest direct operating loans.

3. Congress must provide direct appropriations for interest rate buy-downs.

4. A federally-chartered corporation should be established to assume temporary control of farm and ranch land which has been foreclosed or forfeited to any lending institution. (Provided that there are adequate safeguards written into the law to protect the interests of the previous owner. Lease and/or purchase of any land held by the corporation must be made only to individual farm operators, with the first right to the previous owner and secondly to beginning farmers.)

In order to be successful in implementing these recommendations and resolving the immediate crisis, Congress must appropriate adequate sums of money, the Administration must carry out effectively the intent of Congress, and the lending institutions, be they private or governmental -- as well as the investors -- must absorb a share of the losses themselves.

While tragic losses are already occurring, the worst can still be avoided.

What are needed are preemptive or preventive tactics, not postmortem autopsies.

If this Congress and Administration fail to act until after a far larger disaster, the cost will be correspondingly greater.

In closing, Mr. Chairman, I would like to address an issue which has been raised by some in the Administration, some in Congress, and on some of the editorial pages of our nation's newspapers, namely, why should we be concerned with helping a segment of our society -- the farm economy -- in a time when there are so many demands on our federal budget.

We should do so because it is in the self interest of all Americans. If hundreds of thousands of America's farmers are forced out of business and off the land, they will simply swell the nation's unemployment rolls and be an added burden on federal and state treasuries. Further, the demise of farm numbers of that magnitude will ripple through the American economy putting thousands more workers who are dependent upon farmers for their livelihoods on the unemployment rolls as well.

But there is an even deeper and more long-range reason for taking federal action to avert a major crisis in the farm economy, and it was summed up well at an informal Senate hearing in testimony by Bishop Maurice Dingman of Des Moines, Iowa. In his testimony, Bishop Dingman said:

"The fate of our family farmers is not an abstract concern. What happens to them will determine whether or not a land-owning elite will increasingly control our food, and the price of that food.

"Family-farm agriculture is, we believe, the most sustainable, efficient and community-supportive system yet devised to provide quality food to the larger community, and at an affordable price.

"America's present course, supported and, in many instances fostered by government policy, is destroying our family farms, ruining our resource base...

"Our present course will result in ever more concentrated patterns of land ownership with dire consequences for the survival of our rural communities and for the future of a functioning democracy," Dingman said.

We share Bishop Dingman's concern for the future course of American agriculture as many of you do. Again, Mr. Chairman, we appreciate the concern shown by you and the other Members of the Subcommittee and pledge to work with you and other members of the Congress to resolve this crisis facing not only farmers and ranchers but the entire nation.

Thank you.

FOOTNOTES:

1/ U.S. General Accounting Office. AGRICULTURE OVERVIEW U.S. Food/Agriculture in a Volatile World Economy. GAO/RCED-86-3BR, November 1985. pg.28.

2/ ibid. pg. 14

3/ ibid. pg. 27

4/ ibid. pg. 15

5/ ibid. pg. 29

Chairman LaFalce. The next witness is David Senter, director of the American Agriculture Movement, Inc.

STATEMENT OF DAVID SENTER, NATIONAL DIRECTOR, AMERICAN AGRICULTURE MOVEMENT, INC.

Mr. Senter. Thank you.

The American agriculture community appreciates the opportunity to appear before you today. We firmly believe that unless farmers' net income is increased, that any bailout for the Farm Credit System will be futile.

We do want to go on record that the American Agriculture Movement is not in favor of allowing the collapse of the Farm Credit System. We just want Congress and the American public to understand that a bailout will be temporary help unless farmers get a price so we once again can pay the interest and principal to service our debt.

The economic stress runs much deeper than farmers or farm bankers. In a newly released GAO study, they confirmed the importance of agriculture to the economy. Agriculture employs over 23 million people in the United States and contributes 20 percent of the total GNP. Agriculture is the only sector that has a trade surplus, and yet through our policy decisions in Congress we continue to seek lower prices for our exports when, in fact, the value of these exports is the key to our economy, not volume.

I want to touch on a few problems that continue to come into our office from borrowers from the Farm Credit System. We are getting numerous reports where the Federal land banks and PCA's on the foreclosed farms that they are taking are offering new borrowers reduced principal, sometimes as much as 50 percent reduced, lower interest rates. They are guaranteeing an 8-percent rate for 5 years with no interest due the first year on the loan, and at the end of 5 years, if the new buyer wants, he can cancel the contract with no penalty. The new borrowers are also not required to purchase stock in the PCA's or Federal land banks on these new loans. The problem is that many of the people that are losing their land to foreclosure, if this same package were offered to them, they could cashflow and keep those farms. We believe that in any legislative bailout this problem can be corrected through the legislation, so that these concessions must be offered to current borrowers and not just new borrowers.

Also we are finding an increasing problem across the country that many PCA's and Federal land banks are refusing to provide borrowers a copy of their loan papers. When financial problems develop, it is necessary to see all of the loan papers and documents so that these borrowers can see what options they do have available in trying to refinance and prevent foreclosure. We believe that it should be spelled out through legislation that these borrowers are entitled to a copy of their loan documents within the System.

We also hope that the bailout is not just proposed for the Farm Credit System. Commercial banks and S&L's are a major lender in rural areas, and they must be included in any kind of a package. We believe that passage of legislation to allow farm banks to write off losses over a 30-year period would protect the capital in many of these rural banks, prevent bank failures, and help these banks to work out a plan for borrowers to stay with them when otherwise they could not.

We also have a recommendation that we would encourage this committee to look at that would help these rural banks to loan out more loans to agriculture through reimplementing a program that operated very successfully in the 1950's, which gave borrowers the opportunity to go to a private lender to get a commodity loan. It was up to the farmer whether he went to CCC or to the private lender. The program worked very well then. If the farmer forfeited the grain, CCC would pay the loan off and take title of the commodity. This would allow the rural banks to loan many billions of dollars out and collect the interest off of it, which would help the capital and help many of these struggling banks that have a high percentage of bad loans.

We believe also that the Farm Credit System has made many bad business decisions in recent years. There comes to mind three different building projects just completed, when $25 to $30 million buildings have been built in McLean, VA, Austin, TX, Denver, CO, and hundreds of new buildings in counties all over this country to house Federal land banks and PCA's that now stand empty due to mergers and putting together different counties in the System.

Farmers have paid the price through higher interest rates and stock purchases for these capital investments. We believe that through the legislative process that many of these borrower problems can be addressed at the same time a package can keep the Farm Credit System solid, and can also help commercial banks stay with agriculture borrowers through these times.

Thank you, Mr. Chairman.

[On behalf of the American Agriculture Movement, Inc., the prepared statement of Mr. Senter was submitted for inclusion in the record:]

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America Needs Parity!

TESTIMONY FOR
DAVID SENTER, NATIONAL DIRECTOR
AMERICAN AGRICULTURE MOVEMENT, INC.
ON
FARM CREDIT - FARMER PERSPECTIVE

TUESDAY, NOVEMBER 19, 1985

BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
CHAIRED BY
CONGRESSMAN JOHN LaFALCE

Strength From The Land

Mr. Chairman and members of this Committee, the American Agriculture Movement, Inc. appreciates the opportunity to appear before you today and discuss this important issue for our national food producers and banking industry. We firmly believe unless we increase net farm income, any bailout for the Farm Credit System or other lenders will be futile. AAM is not in favor of allowing the collapse of the Farm Credit System. However, we want everyone to be aware and completely understand that a bailout will only help temporarily unless farm prices increase. When the farmers get a 'price' they could once again pay the interest and principle to service their debts.

The economic stress runs much deeper than farmers or farm bankers. The General Accounting Office(GAO), in a new study, confirmed the importance of agriculture to the entire economy. Agriculture employs twenty percent of the entire nation's work force and contributes twenty percent of the total national GNP. In recent years, agriculture is the only sector of the US economy that enjoys a trade surplus. Why do we seek to lower the price of our exports? When, in fact, the value of these exports is the key to our economy-- not volume.

AAM is receiving numerous reports that have to be addressed, in legislation, to protect borrowers. We are finding that Federal Land Banks are foreclosing and taking farms from farmers. In turn, they offer new borrowers reduced principle (by as much as fifty percent), lower interest rates to eight percent and guarantee this eight percent interest for five years with no interest due the first year of the loan. At the end of the five years, if the new buyer wants to, he can cancel the contract with no penalty. Then, the Federal Land Bank would take the land back. Also, new borrowers are not required to purchase stock in PCA or Federal Land Bank with these new loans. If these changes and opportunities were offered, many current borrowers could cash flow their operations and prevent the loss of their land. These consessions must be offered to current borrowers and not just new borrowers.

Another problem we feel should be addressed in any kind of farm system bailout program is the refusal of many PCA's and Federal Land Bank officials to provide borrowers a copy of their own file. When financial problems develop, it is necessary to see all of the loan papers and all the documents signed to determine what options the borrower has available. In many, many documented cases across the country, the officials have refused to make copies and/or provide any of these records to the borrowers.

We would hope that a bailout is not proposed that would only include the Farm Credit System. Commercial banks are a major lender and must be included to prevent the continued bank failures. Passage of legislation to allow farm banks to write off losses over a thirty year period would protect the capital in these banks, help them work out a plan for borrowers and stay with many customers that otherwise they could not.

The American Agriculture Movement also recommends that a program used during the 1950's be reimplemented which would allow farmers to get their commodity loans from private lenders or the Commodity Credit Corporation(CCC).

In order to increase funding available to finance commodity loans a program to guarantee loans made through private lending institutions should be established. The Commodity Credit Corporation could serve as the guarantor and administer the program.

The program would be similiar to a program enacted in the 1950's. The 1950's program met with a great deal of success in areas with high bank participation rates. For example, a banker in Kansas reported that nearly fifty percent of his loan portfolio consisted of CCC-guaranteed loans.

The program would require a two-tiered sliding loan rate. Farmers borrowing from private lending institutions would receive a higher loan rate to offset the higher interest rate of bank loans. A lower rate would be employed in calculating CCC loans. The loan rates would be recalculated as interest rates fluctuated. The higher loan rate offered by CCC would encourage farmers to get private financing. The interest differential should not exceed a maximum of four percent above CCC interest rates.

If a farmer finances a loan through a private lending institution, he/she would be responsible for repayment at the terms laid out in the contract. However, if the farmers should forfeit the loan, the CCC will repay the loan in full, thus guaranteeing loan repayment. A CCC loan would still be available under existing regulations.

We appreciate very much this opportunity to appear before this committee and look forward to working with you as we try to solve the many problems we face in agriculture.

Chairman LaFalce. Thank you very much, Mr. Senter.

Our next witness will be Mr. Lloyd Cline, vice president of the National Cotton Council, representing the Agricultural Credit Group of Commodity Producers.

STATEMENT OF LLOYD CLINE, VICE PRESIDENT, NATIONAL COTTON COUNCIL AND PRESIDENT, FIRST NATIONAL BANK OF LAMESA, TX, REPRESENTING THE AGRICULTURAL CREDIT GROUP OF COMMODITY PRODUCERS

Mr. Cline. Thank you, Mr. Chairman.

The testimony that I am about to give is on behalf of the following organizations. I would like to name them. National Corn Growers Association; the National Association of Wheat Growers; National Cotton Council; National Cattlemen's Association; the National Grange; National Wool Growers Association; the National Pork Producers Council. Many of these organizations have representatives here with me today that will be available to answer any questions that the committee might have in a few minutes.

Mr. Chairman, my name is Lloyd Cline. I am a cotton producer from Lamesa, TX. I am also president of the First National Bank of Lamesa, TX, about a $100 million bank that is primarily in the agricultural lending business. I am also as you mentioned, vice president of the National Cotton Council.

I am here today on behalf of these organizations that I mentioned a moment ago. These organizations are extremely concerned over the financial state of affairs in agriculture as we know it today—the viability of the lending institutions serving agriculture and the producers per se. Our members are the agricultural families who account for the greatest part of agricultural production here in the United States. They are the borrowers from the commercial banks, the Farm Credit System, the trade creditors, and from FmHA.

We as producers must bear the consequences of any plan that is decided upon that might resolve the credit problem as we know it today.

Certainly a reasonable question for you to ask is, first, why we are concerned, and second, why should Congress and the taxpayers and consumers of the United States be concerned about the agricultural financial crisis that we are in today.

A brief look at the statistics of the financial crisis in American agriculture provides reason enough for concern. We have reviewed several economic analyses of the problem, including some that have been prepared by USDA, and we frankly find the information very frightening. The problem is larger than most of us care to think about.

The absolute level of agricultural debt is great at $210 billion. The share that is at risk is a significant figure, just under 25 percent of the total debt. Recent economic studies indicates that up to $50 billion in agricultural credit may be unserviceable, given present economic conditions in agriculture today. In fact, much of this debt may be unserviceable even under the best of economic conditions that might be realistically expected.

Trying to handle this much "at risk" debt does more than financially strain a few farmers. This unsustainable debt also puts lending institutions, local communities, and agribusiness concerns at risk. The loss of jobs and disruption of communities, which is now significant in many parts of the country, is forcing a tremendous and tragic change on rural America.

We have prepared some data that we have attached to our formal presentation to you, tables that show where the problem is and who holds the debt. We think that this information is a shocking statement of how severe the financial situation really is.

The credit problem, according to this data, extends to all sectors of lending and to all areas of agricultural production.

The commercial producers, the full-time family farmers and ranchers that account for over 70 percent of agricultural production, are the ones that are hardest hit by the present financial crisis.

This problem exists as I mentioned throughout the entire United States. It exists for all sectors of agricultural production and lending. As a result, Congress cannot afford to focus on one sector to the exclusion of the others, nor can it focus on one region to the exclusion of the others. Any kind of relief package must benefit all borrowers, and all the different kinds of lenders throughout this country of ours.

As agricultural organizations representing primarily the producer-borrowers, we have been meeting to discuss the criteria which we think are appropriate to evaluate the various credit proposals that will be considered by you.

The criteria that we urge you to consider as you address the credit problems before us are mentioned here today, not in any significant order but to call your attention to these. Any solution must focus on agricultural producers who are under financial stress, but who would survive with some assistance.

Those who can survive must be helped, but not through more credit. Instead, they need help to handle existing debt. Any legislation must be targeted toward maintaining the financial viability of these farming operations. Debt reduction, interest rate relief, and financial counseling will help many of these producers.

Some form of transitional assistance should be considered to help those whose debts are greater than can realistically be repaid from farming operations, and who must leave agriculture. This transitional assistance may also be the most effective and best means of easing the pain of restructuring that is presently going on.

High interest rates on agricultural loans must be reduced. In some areas, interest rates charged agricultural producers currently range to as much as 6 percent above the rates paid by other industries. Part of this may be due to inherently greater risk in agriculture, but part of the risk may be symptomatic of the structural problems in agricultural lending.

When viewed on a comparable-cost basis, interest rates for agricultural production are substantially higher than long-term rates of return on agricultural assets. This suggests continued erosion in farm asset values.

Agriculture cannot return to financial health until interest rates are more in line with rates of return from the industry.

This next item is more important than any of the others. That is that the farm bill is a necessary part of the solution, and it must be passed as soon as possible. It cannot resolve the entire problem, but I guess it is understandable the sentiment in the Congress, that we ought to try to address the credit problem through the farm bill, because farm programs do help maintain the income of farmers, but it doesn't necessarily touch everyone.

Federal farm programs only directly affect about 45 to 50 percent of all agricultural production, and as we outlined earlier, the credit problem affects all agricultural producers, not particularly one region or another or particularly one size or another, but all producers who are stressed.

Losses are occurring, will continue to occur, and must be shared by all participants in agricultural credit—taxpayers, borrowers, shareholders, lenders, stockholders and so forth. No one segment can withstand the losses that must be taken. Some means of equitably spreading this loss across the board must be considered. We do not support a bailout for any sector. We will bear our share of the loss.

We believe, however, that forcing too much of the loss on one group may create distortions in the general economy.

That is to say we cannot afford the demise of a sector forced to assume too much loss. For example, one source of jobs in rural communities is agribusiness concerns that service commercial agriculture. Forcing these firms out of business will only compound the problem for the local communities that are trying to adjust and absorb the financial losses. Some attrition will be inevitable of course, but we need to avoid the domino effect that it might have on the communities.

A viable means for delivering credit to agriculture is important and must be maintained. This may mean a restructuring of the present agricultural credit institutions and relationships as we now know it, but the result must accommodate the unique biological and cyclical nature of agriculture.

We encourage efforts to maintain present structures, and forego abrupt structural changes until the financial viability of the agricultural credit sector is established.

Preventing this from occurring again is a difficult task, but we must try whatever steps possible to prevent it. We do not have an answer, but it appears to us that oversight and regulation must be improved. The only real long-term prevention is, of course, for agriculture to be profitable.

In conclusion, we urge you to recognize that the problem is massive, it cannot be looked at as a problem of only the lending segment, and will require a coordinated effort on a package of alternatives to be successful. We urge and hope that you will take a broad view of the problem, and the solutions that will be required.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Cline follows:]

Financial Conditions in Agriculture: The Agricultural Credit Crisis

Testimony of

Lloyd Cline

on Behalf of the

NATIONAL CORN GROWERS ASSOCIATION

NATIONAL ASSOCIATION OF WHEAT GROWERS

NATIONAL COTTON COUNCIL

NATIONAL CATTLEMEN'S ASSOCIATION

NATIONAL GRANGE

NATIONAL WOOL GROWERS ASSOCIATION

NATIONAL PORK PRODUCERS COUNCIL

before the
Subcommittee on Economic Stabilization

Chairman La Falace

November 19, 1985

Mr. Chairman, my name is Lloyd Cline. I am a cotton farmer from Lamesa, Texas, and I am also President of the Firest National Bank of Lamesa.

I am here on behalf of several agricultural organizations that are expremely concerned over the financial state of agriculture, and the viability of the lending institutions serving agriculture. Our members are the agricultural families who account for the greatest part of agricultural production in the United States; the borrowers from the commercial banks, the Farm Credit System and the trade creditors—we must bear the consequences of any plan to resolve the credit problem.

A reasonable question for you to ask is first, why we are concerned, and second, why should Congress and the taxpayers and consumers of the U.S. statistics on the financial crisis in American agriculture provides reason enough for concern. We have reviewed several economic analyses of the problem, including some prepared by the USDA, and we find the information frightening. This problem is larger than most of us care to contemplate.

The absolute level of agricultural debt is great at $210 billion. The share that is at risk is significant—just under 25 percent of total debt. Recent economic studies indicate that up to $50 billion in agricultural credit may be unserviceable given present economic conditions in agriculture. In fact, much of this debt may be unserviceable under even the best of economic conditions that might be realistically expected.

Trying to handle this much "at risk" debt does more than financially strain a few farmers. This unsustainable debt also puts lending institutions, local communities, and agribusiness concerns at risk. The loss of jobs and disruption of communities, which is now significant in many parts of the country, is forcing a tremendous and tragic change on rural America.

The data in the attached tables show where the problem is and who holds the debt. We think this information is a shocking statement on how severe the agricultural financial situation is at present.

It is particularly instructive to look, in Table 1, which shows lenders holding the 'bad debt' or the debt "at risk" of full or partial loss. It is not, contrary to popular opicnion, confined to a certain segment—the credit problem extends to all sectors of lending and all areas of agricultural production.

Debt concentration by type of farming operation is shown in Table 2. One conclusion that can be drawn from this table is that the commercial producers—the full-time family farmers and ranchers that account for over 70 percent of agricultural production—are hardest hit by the present financial stress.

Debt concentration by region is shown in Table 3. While some areas of the country appear to be harder hit, no area is unhurt. This problem exists throughout the U.S.

The problem exists for all sectors of agricultural production and lending. As a result, Congress cannot afford to focus on one sector to the exclusion of the others, nor can it focus on one region to the exclusion of others. Any kind of relief package must account for borrowers, and for the different kinds of lenders, throughout the country.

As agricultural organizations representing the producer/borrowers, we have been meeting to discuss the criteria which we think are appropriate to evaluate the various credit proposals that will be considered. We are also working on a credit relief package that the agricultural groups can accept and support. Any package so developed will meet the criteria we are about to outline. We expect to have a proposal for your consideration within the next few weeks.

We urge you to also consider these criteria as you address the credit problem. The focus of the criteria is on establishing an agricultural credit relief proposal that is helpful and acceptable to agricultural producers. The criteria are general, but succinct.

Any solution must focus on the agricultural producers who are under financial stress, but who would survive with some assistance. Those who can survive must be helped, but not through more credit; instead, they need help to handle existing debt. Any legislation must be targeted toward maintaining the financial viability of these farming operations. Debt reduction interest rate relief and financial counseling will help many of these producers.

Some form of transitional assistance should be considered to help those whose debts are greater than can realistically be repaid from their farming operations, and who must leave agriculture. This transitional assistance may also be the most effective and best means of easing the pain of the restructuring that is presently underway.

High interest rates on agricultural loans must be reduced. In some areas interest rates charged agricultural producers currently range from about 3 to as much as 6 points above rates paid by other industries. Part of this may be due to inherently great risk in agriculture, but part of the difference may be symptomatic of structural problems in agricultural lending.

When viewed on a comparable cost basis, interest rates for agricutural production are substantially higher than long-term rates of return on agricultural assets. This suggests continued erosion in farm asset values.

Agriculture cannot return to financial health until interest rates are more in line with rates of return from the industry.

The farm bill is a necessary part of the solution, but it cannot resolve the whole problem. An understandable sentiment in Congress is to try to address credit through the Farm Bill. However, this is at best only a partial answer. The Farm Bill serves as a guide and risk management tool for some producers, but cannot begin to reach all segments of agriculture.

Farm programs *can* help maintain net farm income (at $20 - 25 billion). However, the federal farm programs only directly affect about 45 to 50 percent of all agricultural production. As outlined earlier, the credit problem affects all agricultural producers. It is not especially size or region specific--all producers are distressed.

Losses are occurring, will continue to occur and must be shared by all participants in agricultural credit: taxpayers, borrowers, shareholders, lenders, stockholders, etc. No one segment can withstand the losses that must be taken. Some means of equitably spreading this loss across the broad economy must be considered. We do not support a bailout for any segment either; we will all bear our share of the loss. We believe, however, that forcing too much of the loss on one group may create distortions in the general economy.

We cannot afford the demise of a sector forced to assume too much loss. For example, one source of jobs in rural communities is agribusiness concerns that service commercial agriculture. Forcing these firms out of business will only compound the problem for local communities trying to adjust and absorb the financial losses. Some attrition will be inevitable, but we need to avoid a domino effect.

A viable means for delivering credit to agriculture is important and must be maintained. This may mean a restructuring of present agricultural credit institutions and relationships, but the result must accommodate the unique biological and cyclical nature of agriculture. This area is the most important, and cannot be forgotten in an attempt to handle the immediate problem. We encourage efforts to maintain present structures, and forgo abrupt structural changes until the financial viability of the agricultural credit sector is established.

Mechanisms to prevent this financial crisis from occurring again. Preventing this from occurring again is a difficult task, but we must try whatever steps possible to prevent it. We do not have an answer, but it appears to us that oversight and regulation must be improved. The only real long-term prevention is, of course, for agriculture be profitable.

In conclusion, we urge you to recognize that the problem is massive, it cannot be looked at as a problem of only lending segment, and will require coordinated effort on a package of alternatives to be successful. We urge and hope that you will take a broad view of the problem, and the solutions that will be required.

Table 1: Agricultural Debt, and Agricultural Debt "At Risk"

Source	Total debt (bil $)	Estimated At Risk (bil $)
Farm Credit System	$ 70.0	$ 2 - 11
Commercial Banks	56.0	1.5 - 4
Farmer's Home Admin.	26.0	13 - 15
Insurance Companies	12.0	.5 - 2
Trade Credit	18.0	7 - 10
Individuals	28.0	4 - 8
Totals	$ 210.0	28 - 56

Source: The numbers are based upon USDA data, recent economic analyses and the published statements of the various lending institutions. These are not numbers generated by the agricultural groups; These are the range of estimates offered by lenders within the past few months.

Table 2: DEBT CONCENTRATION BY FARMING OPERATION

		TYPE		
	CROPS	BEEF	PORK	DAIRY
	D/A	D/A	D/A	D/A
GROSS SALES CLASS				
Less than 10,000	18.93	10.85	16.61	22.85
10,000 - 24,999	16.50	9.22	37.27	12.45
25,000 - 49,000	30.21	17.15	30.51	41.64
50,000 - 99,999	43.04	30.27	39.36	24.07
100,000 - 249,999	41.95	28.36	61.56	22.20
250,000 - 499,999	50.48	45.44	60.60	34.32
500,000 and over	32.40	44.32	36.16	33.36
All	36.07	19.45	47.56	25.58

*CROP PRODUCERS INDICATE GREATEST FINANCIAL STRESS IN MID RANGE FARMS FROM $50 TO $500 THOUSAND IN GROSS SALES.

*BEEF PRODUCERS HAVE LOWEST TOTAL DEBT TO ASSET BUT LARGER PRODUCERS, ABOVE $250 THOUSAND, INDICATE FINANCIAL PRESSURE.

*PORK PRODUCERS CARRY HIGHEST DEBT/ASSETS WITH TWO CLASSES IN THE HIGH STRESS CATEGORY, $100 TO $500 THOUSAND GROSS SALES.

*SMALL DAIRY FARMS, $25 TO $50 THOUSAND INDICATE HEAVY FINANCIAL STRESS.

SOURCE: Farm Journal survey; December 1, 1984, and the Food and Agricultural Policy Research Institute (FAPRI).

NOTE: "Type" of operation based on percent of gross sales. For example, an operation was called a "CROP" farm if 70 percent of sales came from crop sales. For Beef and Dairy, 50 percent was used, and 30 percent for Pork.

Table 3: DEBT CONCENTRATION BY FARM SIZE

	REGION				WEIGHTED NATIONAL AVERAGE
	EAST	SOUTH	CENTRAL	WEST	
	D/A	D/A	D/A	D/A	D/A
GROSS SALES CLASS					
Less than 10,000	13.78	13.07	15.57	15.53	13.93
10,000 - 24,999	9.14	7.97	23.60	21.18	15.02
25,000 - 49,000	11.96	28.43	29.44	27.70	27.88
50,000 - 99,999	25.87	43.17	39.07	26.43	37.76
100,000 - 249,999	23.56	38.01	43.42	25.73	38.52
250,000 - 499,999	41.26	33.48	54.03	41.49	48.41
500,000 and over	13.64	22.93	43.45	43.15	35.19
All	20.85	25.30	38.37	27.32	31.80

*EAST HAS LOWEST DEBT/ASSET RATIO WITH HEAVIEST FINANCIAL STRESS IN $250 TO $500 THOUSAND.

*SOUTH INDICATES HIGHEST FINANCIAL STRESS IN $50 TO $100 THOUSAND.

*CENTRAL RELECTS HEAVIEST CONCENTRATION OF FINANCIAL PRESSURE STARTING AT $100 THOUSAND AND ABOVE.

*WEST INCIDATES GREATEST FINANCIAL STRESS IN FARMS ABOVE $250 THOUSAND.

SOURCE: See Table 2.

Chairman **LaFalce**. Thank you very much, Mr. Cline. I will defer my questioning until the end in order to enable all the other subcommittee members to ask their questions. I will first call upon Mr. Vento.

Mr. **Vento**. Thank you, Mr. Chairman.

I would like to extend a special welcome to my former colleague in the House and the recent Secretary of Agriculture, Mr. Bergland. I met you for a series of hearings, even if I haven't been here for each of the hearings, I have been here for some of them. I am with you in spirit because I think it is what needs to be done in terms of educating ourselves in providing a public forum for the discussion of farm credit and problems that the farm economy, the agricultural economy, is experiencing.

Just a couple of questions. Mr. Cline, in your statement I am looking at tables 2 and 3. I don't know what these tables are. Are these dollars that they indicate, the gross sales class, the debt concentrate for farming organizations? Is that what this represents? Is this billions of dollars, millions of dollars? Is it percentages? I don't know.

Mr. **Cline**. This is dollars, yes, sir, the gross sales class.

Mr. **Vento**. What type of dollars are those? Something is missing from the target. Let's not take the time now, but be sure and provide that and make that complete for the record, because just in looking at it, I assume it is——

Mr. **Cline**. The categories, for instance, may I just explain briefly, less than $10,000, $10,000 to $24,999.

Mr. **Vento**. I know that, but I am looking at under crops it is 18.93 what, debt to asset ratios?

Mr. **Cline**. Debt to asset ratios, percentage.

Mr. **Vento**. I guess that is clear.

Almost all of you have indicated that there is no fix that is possible unless we get an adequate farm program, is that right, a program that will work? Do any of you disagree with that?

Mr. **Cline**. No, sir, I don't.

Mr. **Vento**. Does anyone else disagree with that?

Mr. **Bergland**. Mr. Vento, I think it goes beyond the traditional commodity policies. I think there has to be an overhaul of our national fiscal policies as well, because I believe the deficit structure is affecting the exchange rate of the U.S. dollar, and that it is putting U.S. agricultural exports at a competitive disadvantage in this world. We are not going to restore prosperity to farming by lowering price supports to offset that factor. We simply need to rearrange our Federal fiscal structure in such a way that the dollar returns to a more traditional value.

Mr. **Vento**. Isn't that the group of five that met that I think Secretary Baker should be applauded for that group of five meeting in the way that the dollar has progressed since then, at least relative to the yen.

I haven't followed the mark and the other dollar values as closely. I guess the Japanese have done the best job in terms of reducing that, and I think that that is a concern. That, of course, is sort of a long-term factor, but that would have to continue to be addressed, I guess, through some formal arrangement like the Bretton Woods Agreement, or some other forum, in which the bloated dollar would continue to be addressed, in that particular phenomenon in terms of the free floating dollar, so to speak, would not be permitted to move in that direction, because that has caused all sorts of difficulties with which you are concerned, I guess, but you have to recognize that there have been some movement in that area.

Mr. BERGLAND. There has been, Mr. Vento, but the experience in these matters suggests that intervention by the national banks simply cannot overcome the powerful offsetting conditions of the U.S. deficit, and the borrowing requirements of the American economy are really sucking moneys in from overseas, and that is what distorts the value structure.

While there has been some change vis-a-vis the yen recently, I am not at all comfortable that this is a permanent and market denominated trend, and it leads us to believe that we really do need to deal with the deficits.

Mr. VENTO. I think that is probably true, that we need to do something with regard to deficits, but you know, part of that would get right back into taking money out of perhaps the credit system, for instance, the Farm Credit System or the Farmers Home Administration.

As I look at this, for instance, it looks to me like from the chart that has been provided that the National Government is at risk with regard to Farmers Home Administration, the Commodity Credit Corporation, for about two-thirds of the debt right now, aren't we?

I mean the Farmers Home Administration by definition and the Commodity Credit Corporation, we are at risk for about two-thirds of that agricultural debt right now, aren't we?

Mr. BERGLAND. I think that is right, Mr. Vento. I would have to yield to my colleagues for expert judgments, but I think all of us would agree on one thing, that basically the problem here is the question of farmer income. That unless we can treat the farmer income side of this matter effectively, the credit side is simply never going to be solved. It will just require larger, and larger amounts of moneys punched in, and it will cure nothing.

Mr. VENTO. I know, but when you talk about the deficit, that is part of the reason that we have a deficit, at least, is because of the programs we have.

Mr. BERGLAND. True.

Mr. VENTO. Programs in toto.

Mr. BERGLAND. Yes.

Mr. VENTO. And so I mean the farm programs are part of that scheme, and if at the same time we are trying to reduce the program, we are going to have a greater contribution made apparently to make good on the Farmers Home Administration debt and the Commodity Credit Corporation debt, and then we are going to have, I guess, loans going to the Farmers Credit Administration or system and/or the rural banks through some sort of Federal or national devise.

Mr. BERGLAND. That is true. I was visiting with a friend who is in the flour milling business out of Minneapolis. They were bidding on a Japanese flour contract. Their competition was Canada, and the Japanese importer had to convert the yen to the dollar first, before they could buy the commodity.

When they got into the conversion to American dollars vis-a-vis the Canadian dollar, there was no competition. The Canadians beat us hands down. The qualities of the grains were the same, and so the growers out there were stuck.

Now the point is the remedy suggested is to lower support rates, that the way to compete with the Canadians is to lower support rates. This simply is unfair. That will worsen the credit matters even beyond that which we see today, and so our point, Mr. Vento, is that we have simply got to deal with the exchange rate question.

Mr. VENTO. I think that we agree on that, Mr. Secretary. The one point I wanted to make though with regard to this before we leave this whole international area is the sort of emphasis on exports dependent type of industry.

I mean, it is true that today in the marketplace, for instance, with regards to soybeans and with regard to other grain and commodities that a lot of other nations who have not produced these are now doing so, so that the world is kind of a different marketplace than it was in the early 1970's for U.S. feed grains and soybeans and so forth, is it not?

Mr. BERGLAND. Yes. The world's grain production has been doubled on a per capita basis in 30 years.

Mr. VENTO. That is due to another Minnesotan and Norman Borlaug.

Mr. BERGLAND. Dr. Borlaug has contributed to it but the fact is that the whole world is discovering new technology. American seed companies are finding it profitable to set up subsidiaries overseas and producing new seeds in these countries, irrigation systems being installed overseas by private enterprises.

Yields are increasing right along, and countries that used to be considered basket cases like India, for example, I can remember 20 years ago people were forecasting devastating food shortages in India, now it is a surplus producer.

Mr. VENTO. My time has expired, surely, but I was just going to say, you know, that we have got a technique it seems for everything. It seems like everything is export driven, that is to say, they don't have the money to buy the grain. They borrow the money to buy the grain. If they don't have the money to pay the debts we write down the debts, not just the farmers, I am talking about foreign purchasers of export policies.

We have sort of run that string out. While I agree with you on the value of the dollar in terms of exports and some of the others, I think we also have to be realistic in terms of how much of the market is going to be dealt with on an export solution basis and how much is going to be dealt with on a domestic production basis, and that gets back I guess to some conclusions concerning production, and the role of the National Government in this sphere that are unpleasant for all of us to go back and revisit, because it isn't the way that we have been talking for the last 15 years, but nevertheless I think that is where it is at.

Mr. BERGLAND. Mr. Vento, just one closing comment. Of the exports in agriculture, about a third go to the industrial world, Europe, Japan, Canada and places of this sort, where the exchange rate question is the driving and competitive element.

About a third goes into countries of middle but rising incomes. The balance goes into countries that are really very, very poor. The growth opportunities in exports will not take place in Europe and Japan. There we are fighting for market share. The real growth opportunities are going to be in the poor Third World, where the overwhelming problem is poverty.

Mr. VENTO. And they don't have the income to buy?

Mr. BERGLAND. They have nothing; yes, sir.

Mr. VENTO. So they have to borrow it and it has to be worked out. All of this is sort of related to the broader topic that this committee obviously deals with in terms of the credit system on a global basis.

Mr. BERGLAND. Yes, sir.

Mr. VENTO. Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you. Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

Gentlemen, I appreciate the opportunity of your coming here. It is always educational, irrespective of our thoughts and how they may or may not coincide.

I was struck by some of the comments that were made about the need to improve farm income. I believe you mentioned that, Mr. Secretary, and I certainly couldn't agree with you more, because I have difficulty restructuring the credit system, extending loans irrespective of how this is done mechanically. If at the end of this restructuring and loan adjustment, income is not available to service that debt to the degree necessary after the restructuring, it is just postponing the inevitable.

We have created a production monster, in my opinion. My father's roots are in central Kansas, where they used to get 16 bushels to the acre, and those of his family who are still there are getting far more than that now. The farms are larger, because of the economic necessity of spreading your costs, and so I have a little problem with the other comment that was made about the individual owner-operator versus what is a viable sized unit for production now relative to the costs of the items involved to produce that end product, harvesters, tractors and so forth, which no longer costs $5,000 or $6,000, but get up to $50,000, $60,000, or even $100,000. You can't spread that over 40 acres or 80 acres like you used to.

I don't know that any of you would want to comment on that, but I just have a problem in improving or restructuring the loan system unless we can see light at the end of the tunnel as far as income to pay for it is concerned.

Do any of you have any comments on that? I would be interested in them.

Mr. MULLINS. Mr. McCandless, I couldn't agree with you more. If there is no prospects of repayment, this Congress is going to be asked to flush $3 billion, $6 billion, $10 billion down the drain.

If you bail out the system for $3 billion—and I am not saying that something doesn't have to be done, but as you point out, if there is no prospect for price enhancement, you simply, as you said, are postponing the inevitable. We have got to have that, and quite frankly, the best that this Congress has offered us so far in terms of a farm bill and price support is what the House has come up with, and that guarantees a 20-percent reduction in farm income over the next 4 years.

Mr. **McCandless**. We talked about the value of the dollar, and I don't think anyone can disagree with the fact that it is overpriced and is a part of the problem, but even given that correction to a reasonable degree, the cost of producing a bushel of wheat in Argentina and other locations that we are in competition with is still far less, and in many cases the commodity being sold is equal to or near that of ours in quality for the third party's purchase, so we have what I would consider for purposes of our discussion a world surplus of a commodity begging for a piece of an existing market that even an adjusted dollar is not going to give us what we need in the way of additional markets.

Would you fellows agree with that?

Mr. **Senter**. Mr. McCandless, I would like to make a comment. In most cases the people that continue to push for more productivity, higher production levels, more exports, are the people that benefit from higher exports through the services and the agri-business sector. Most farmers, and we firmly believe the majority of farmers, are willing to accept supply management in agriculture. That is what Congress has not addressed in this new farm bill.

We believe very strongly that the United States should implement a program to sit down with our competitors and try to reach an agreement on market shares. That would be much more beneficial for the different producers of wheat and grains and commodities to agree that the United States has a 40-percent share, to agree upon those market shares, instead of entering a program to try to continue to lower the U.S. price which is going to result in a trade war with all of our competitors where everybody loses.

We just think we have to face up. We can produce more than we can sell. We can't continue to produce for an imaginary market. It is bankrupting agriculture, the Treasury, and in Third World countries around the world whom we turn around and loan money to through the World Bank and International Monetary Fund to bail them out.

Mr. **McCandless**. A last question if I may, Mr. Chairman, which deals with the loan process. Having come from the auto industry, and saying to myself, gee, it is kind of a survival of the fittest, and then all of a sudden the Federal Government comes in and guarantees loans on Chrysler, which I didn't have anything to do with at that time, one of my biggest competitors.

I had a little trouble with that. I still have a little trouble, but it proved to be a satisfactory arrangement financially, from the various standpoints of view.

If we were to apply that kind of an approach, what is wrong with the Federal Government rather than actually getting in or increasing its involvement in the loan business, or setting up new structures or revamping existing structures, what is wrong with doing "the Chrysler route or Lockheed route"—the Federal Government simply saying to the private sector, we will guarantee a certain amount of these loans, given conditions that are acceptable and must actually be agreed to?

Mr. **Frazier**. Let me try that one for a moment, Mr. McCandless. I think most of us appearing here today would expect that if this

Congress is to do something constructive with the whole problem that we have laid out, it would be in the form of underwriting some new money, perhaps reorganizing the farm credit structure. I would hope that it could be handled without calling for unlimited amounts of money out of the Treasury.

But certainly this farm credit paper that has not been underwritten by the Government in the past, even though some of the investors thought that it was, needs to be guaranteed or underwritten in some practical fashion now, if we are to refinance the whole structure of the land bank and the PCA's.

Mr. McCANDLESS. The point I am getting at here is an infusion of new captal requires that we go out and borrow, which means then that becomes a part of our budgetary process. A guarantee is not payable until the terms and conditions of the loan require that the guarantee be forthcoming, and so you have a different kind of situation there as far as the budgetary process is concerned, which would appear to me to be more palatable to the Congress in its present mood of trying to find answers to its problems.

Mr. FRAZIER. We, of course, do not know what Mr. Jones is going to bring forth over in the subcommittee where he is working on this bill now, but it is my understanding that the guarantee or underwriting feature is a matter of serious consideration. We would hope for that solution rather than just a direct Treasury loan or bailout.

Mr. McCANDLESS. Thank you, gentlemen. Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Gentlemen, welcome. We very much appreciate your testimony. For the record, I would like to share some information I have received from the Federal Farm Credit Bank's Funding Corporation, and I will give it to the full committee. I will give it to the committee to its full extent, but I would like to just mention a couple of the statistics on the chart.

This indicates the breakdown of purchasers of the farm credit securities; in other words, who is buying the farm credit securities at this point. The most recent data was for the year 1984. At that time, 49 percent of those securities were being purchased by commercial banks for portfolio trust or other purposes, 16 percent by State and local governments, 10 percent by mutual money market and investment funds, 4 percent by foreign purchasers, and 7 percent by thrift institutions.

So the thrift institutions and the banks, the commercial banks, are holding a lot of this paper right now, the majority of it as a matter of fact. I think there is probably a decline in that; if the decisions of agricultural bankers in my State is any indication, they are getting rid of it, or they are not buying it as they once did.

I have three questions that I would like to address to the entire panel, and have any or all of you respond as you care to. Today I understand the chairman and the ranking member of the Agriculture Committee and the Agriculture Subcommittee, the Agriculture Credit Subcommittee, those four gentlemen have dropped a bill in, or are about to, on farm credit, and it basically has three elements, and I want to get your reaction to it.

The first two are found in everybody's proposal in some way, a restructuring of the existing Farm Credit System or what they call self-help. Second, creating greater financial regulatory responsibilies and placing them on the Farm Credit Administration. But the third part is the interesting part, on which I would like to have your reaction.

It provides for discretionary backstop aid from the Federal Government, and it does it when two conditions are met: when the Farm Credit Administration certifies that the System needs financial assistance, and, two, when it certifies that the System has committed its own available capital surplus and reserves to the point where further drain on system resources would probably leave its institutions unable to serve its borrowers on reasonable terms.

Now, if the Farm Credit Administration makes that certification, the Secretary of the Treasury would have the authority at his own discretion to buy any obligations issued by the Farm Credit System Capital Corp. and to provide terms for repayment of the assistance, up to the extent of $3 billion. It is a discretion on his own authority, when those two conditions are said to be met by the Farm Credit Administration, the Secretary of the Treasury can take that discretionary action to backstop the System.

I had thought about this, only I had been thinking about a mandatory trigger. I wonder what your reactions are to that. It is different, of course, than the line of credit proposal. It does lay down conditions that have to be found and certified.

Mr. MULLINS. I will lead off, Mr. Bereuter. I have real problems—and we just received this so we haven't done a careful analysis or seen the actual language. But just from what I am reading here, I would have a real question about making the authority discretionary with the Secretary of the Treasury. I think once certain criteria are met, that it should be mandatory, and quite frankly I don't think $3 billion is going to be enough money, even in any one single year, to undergird the System.

Mr. BEREUTER. All right, who else would share reactions?

Mr. CLINE. Our groups met this morning and talked about it, very briefly, of course. We just received the news release early this morning. We agree with the first two items on it, I think, without question. The third item we have some problems with at this time. One is that depending on how those reserves were used up, if there were actual losses or if there was some collateral there to support part of that loss that may have been transferred off as a loss, we have some problem with the fact that the $3 billion figure is in there.

We don't think this is enough. We think that there is going to be a larger amount than that, that it is going to be spread and should be spread over more than just the Farm Credit System. We think other agricultural lenders should be involved in it, in any kind of a help situation that it is, whether it be a bailout, a guarantee or what, and very frankly, we have not had the time to study it as well as we want to.

We would be glad to furnish the committee with our thoughts at a later date, after we have had time to really review the bill itself rather than a news release. That would be our position as a group of organizations.

Mr. **Frazier**. I would comment just briefly along the lines that the other gentlemen offered, but I would make two specific points. Spokesmen for the administration appearing before the Agriculture Committee seemed to indicate a rather firm belief that they would not need to come forth with assistance for another year, 18 months, or something of that sort. This sends a cold chill through my people when we talk about it. We are sure that we will face a problem before then.

I would fear this discretionary authority. I think they would be inclined to exhaust resources within the System before they offered assistance, and that would be bad.

The second point, said right quickly, the interest rates have been rising on this money in the market. If this program is devised and the Congress is a little more forthright, they may turn down that interest rate which will be a great help, considering the amount of money involved.

Mr. **Bereuter**. Would you favor assistance upon the certification that those two conditions are met, if, in fact, it was a mandatory backstopping?

Mr. **Frazier**. Yes, I would like a firmer program than this.

Mr. **Senter**. Mr. Bereuter, a comment on the $3 billion proposal. The $3 billion in our opinion, if you add a Chrysler-type style guarantee to it, might be able to solve the problem. We believe that it would be a much stronger program if you had a guarantee under the bonds and other program structure, coupled with some direct money that would be available to infuse into the System, and we would prefer to do away with the discretionary authority and put triggers in it so that on a mandatory-type basis when that trigger was met, the infusion of cash would occur, so you don't have a 2- or 3-month time here when you could see serious failure within the System waiting for a political decision to be made.

Mr. **Bergland**. Mr. Bereuter, one of the provisions of the bill would restructure the Farm Credit Board into a five-member full-time presidentially appointed group, appointed to 6-year staggered terms, one of whom would be selected by the President to serve as Chairman and Chief Executive Officer.

It seems to me that this sort of direct and firm control gives the executive branch the necessary safeguards so that while this group can operate with some independence and autonomy, taking their farm credit responsibilities as their challenge and charge, at the same time the President's and the executive's overall broader responsibilities are safeguarded by these appointments processes. The role of the Secretary of the Treasury therefore should not be carte blanche, but incorporated in an advisory or reference capability.

Mr. **Bereuter**. Thank you, Mr. Secretary and gentlemen. I think my time has expired. I will wait for my next two questions.

Chairman **LaFalce**. Thank you. Gentlemen, this subcommittee has had some experience dealing with difficult financial situations experienced by constituencies throughout America—the New York City loan guarantee, Lockheed, and the Chrysler loan guarantees, et cetera. We may well have legislative jurisdiction at least over title III of the bill that is probably going to be introduced today. So that you are aware, speaking for myself and only for myself, I would have insuperable difficulty with any mandatory trigger.

It would seem to me imperative that Treasury at all times have discretion to work out a deal. We certainly gave the Treasury Department discretion in the Chrysler situation. We gave discretion in the New York situation. The mere fact that the legislation was passed, though, was an exhortation by the Congress for the Treasury to act, but again only under a certain set of circumstances. The Congress could establish the criteria that they had in mind, but they couldn't make the final judgment as to whether this had to be appropriately an executive branch decision, whether it was in a Ford or Carter administration or now a Reagan administration.

I would think that there might be some reluctance on the part of others to go along with a mandatory triggering too, as opposed to discretion. Obviously, members of the Agriculture Committee have that thought in mind, too, because apparently the bill they are introducing would be discretionary rather than mandatory.

A number of you made the point that we shouldn't come to the assistance of the Farm Credit System without coming to the assistance of other agricultural lenders. Does that mean that you would vote against title III of the bill that we suspect is going to be introduced today, because it would only give potential financial assistance, as I understand it, to the Farm Credit System?

Mr. CLINE. If I might answer that first, and may I add just a little bit to the question mentioned earlier. I think that our group would agree with you that it should be discretionary. I think also that we feel that a guarantee-type program would be just as well as a direct package of money, because if the Federal Government puts a guarantee behind these bonds, it is in effect as strong a bond as the Federal Govenment's direct obligation, and I don't see the need, if we are going to put a guarantee behind those bonds, to go back and to infuse capital in addition to those guarantees. The private sector market should be able to have plenty of money available.

Chairman LAFALCE. You don't want a guarantee of all $70 billion, you are talking about a guarantee of $3 billion?

Mr. CLINE. A guarantee of a figure, the problem loans, if I might put it that way. No, not the full $70 billion.

Chairman LAFALCE. What would you guarantee?

Mr. CLINE. The guarantee of bonds that might be necessary there to supply money for the capital corporation they are talking about.

Now, to go ahead and answer the question that was raised concerning whether or not we would want to vote against the help that they are asking for at this point in time, I think we simply say that we feel that the credit crisis is larger than the Farm Credit System. Some of the other crises in the other sectors of lending have not shown up yet.

Maybe it has not been admitted by those lenders, and we as producers feel that it is going to be necessary for some help to other commercial lenders in addition to the Farm Credit System, and it may be that it will be necessary to come back at a later date. We don't want to close the door and say that this help to the Farm Credit System is the only one that will be necessary.

Chairman LAFALCE. But the bill is up tomorrow and we are going to vote on this yes or no, with respect to title III. We are not going to help agriculture banks. We are not going to pass a farm bill. We are not going to deal with the income problem. We are simply going to deal with this credit problem to the tune of $3 billion exclusively for the Farm Credit System. Now, a good many individuals here have said, do this, but don't do it if you are not going to deal with the income problem, otherwise it will be throwing good money after bad. That may be——

Mr. **Frazier**. Let me try quickly, Mr. Chairman. I raised the question. I was speaking to you as Members of the whole Congress and encouraging you to take somewhat of a benevolent attitude toward this farm bill because I don't think it is settled yet by any means. After the Senate finally acts, it is coming back to you and it is going to be quite difficult; and it also will be with you early next year. I only meant to emphasize the need for some income out of the farm level.

Chairman **LaFalce**. The Reagan administration has taken this position—they are saying we do need a reorganization of the Farm Credit System.

Mr. **Frazier**. Yes, sir.

Chairman **LaFalce**. We do need much greater supervisory authority given to the Farm Credit Admnistration.

Mr. **Frazier**. Yes, sir.

Chairman **LaFalce**. That, in and of itself, should enable us to at least buy some time. It should stabilize the spread that has come about in the interest rates from what they were and what they are now. They feel rather strongly about that, and they are not saying that we won't consider extending some possible financial assistance or at least making it possible. But they are saying before we do that, let's get the Farm Credit System and the Farm Credit Administration's house in order. Then as we are doing that, we will consider the need of additional financial assistance.

Mr. **Frazier**. Yes, but they have also said some other things, sir. I can't quote it exactly now because I don't have it before me, but they have actually announced the schedule in which they would shift much of the Farmers Home Administration loan program over to a guarantee program rather than to use some direct loans, which our people will sorely need out there in the country.

So for my part, I was trying to encourage your recognition, even though you may vote on title II of this bill as such, I would hope in handling the bill and in the record you create that you would keep open the opportunity for farm banks and the FmHA to benefit by somewhat better policies than we find downtown right now, because they are not helping in those areas, and apparently don't propose to.

Chairman **LaFalce**. You gentlemen are involved on a daily basis with the problems of farmers, the problems of the Farm Credit System and the problems of the farm banks. Why should we treat farm banks differently from the way we treat thrifts, savings and loan associations that have had difficulties because of their long-term portfolios at low-yielding fixed interest rates? We are not doing anything to help them. Why should we help agriculture banks when there are other banks in difficulty because they loaned in predominantly energy areas, and those have now turned sour.

Why should we help agriculture banks when some banks are in difficulty because of Third World debt? You know, why should we help the farm sector when we have lost millions and millions of jobs in manufacturing in the past several years and everybody said, "Oh, you certainly shouldn't have any direct loans or guaranteed loans for the industries of America, that would be an inappropriate industrial policy to be picking winners and losers. It would be in violation of the system."

Mr. SENTER. Mr. Chairman——

Chairman LAFALCE. I ask this as a devil's advocate not because I am opposed to assistance, but it is just that if we are to give assistance here, could not other claimants come before us with equal merit or would their merit be less?

Mr. SENTER. On the agriculture banks, from the FDIC, we understand there are in excess of 400 farm banks now that they could close that are having serious financial problems.

Chairman LAFALCE. Would that be good or bad? Should there be greater consolidation within our banking system? Is it smart to have banks today that are almost totally reliant upon or totally involved in agricultural loans as opposed to having a diversified portfolio?

Mr. SENTER. There are those that say we have too many banks, that is the reason we are having bank failures and there are those that say we have too many farmers is why we are having farm failures. What you see happen in areas where you have seen many independent banks bought up by holding companies and interstate banks, all of the money from these rural areas are being siphoned out into oil company mergers and all kinds of billion dollar loans to foreign governments and a whole host of things, which has left the agriculture community and even the business community in these areas unable to borrow money from those banks, whereas when you have the small rural-type banking system, they invest all of those dollars back in the community for capital improvements and a whole host of other things so they are actually spurring the economy in those areas.

We think the proposal that we make would not cost money to the Government for these agriculture banks. It would be a change in allowing them to write off losses on loans over a number of years instead of having to take a writeoff in 1 year.

There were similar changes made for S&L's a few years ago that allowed them some change to help them out of the problems that they were having. We just believe that not in the same legislation, but you need to have the door open through some parallel legislation that is going to be necessary, because either we are going to have to move this lending——

Chairman LAFALCE. If we allow agriculture banks to write off their bad loans over a longer period of time, would be we have to permit all banks to write off all their bad loans, regardless of who they made it to over the same period of time? What would be the consequences for the safety and soundness of our banking system, or do we have to treat agriculture loans differently from other loans?

Mr. SENTER. I would think that the committee would probably have a better feeling as to whether or not all banks would have to be treated equally or not.

Chairman LAFALCE. Mr. Cline, you are a banker. Do you have any thoughts on this?

Mr. CLINE. Your points are well taken and I agree that the problem lies there. To answer your question, I think we come back to, for instance, the Continental Illinois Bank that had energy loans and it had foreign loans, and the President said that we assist these people that had energy loans, that had foreign loans, and so forth.

Chairman LAFALCE. Congress didn't, but there was a regulatory scheme in place that did.

Mr. CLINE. But the Federal Government did as such. Maybe the Congress didn't, but it was guaranteed by the Federal Government in effect or money put into it by the Federal Government.

Chairman LAFALCE. There was one difference. There was a legal backing by the government of that bank. There is no legal backing to my knowledge, of the Farm Credit System.

Mr. CLINE. Implied only, yes. No legal backing, but an implied guarantee.

Chairman LAFALCE. Implied legal is one that is nonlegal; is that correct?

Mr. BERGLAND. Mr. Chairman, my son-in-law is an officer of the Citizens State Bank, Roseau, MN, the only bank in our county seat town. That bank has something under half its loans in agriculture. They are at the limit by all present banking standards. If the PCA in our community is forced to fold up, those borrowers have no place to go because that bank cannot by its own resources take on additional loans.

So the problem is as the small banks close and as the PCA's struggle with their problems, where do the borrowers go? A bank holding company bought a number of these rural banks and now announced they intended to sell 30 of them. Anything with an agriculture lending base is for sale. There is no profit in it and that is why those people are getting out of it.

Chairman LAFALCE. What do we do about those banks, because this bill is not going to address the problem of the banks. It would address the problem of the PCAs.

Mr. BERGLAND. The problem is that the entire farm credit structure is on the verge of hemorrhaging and may come apart at the seams. It would help stave off a real calamity.

Chairman LAFALCE. Is there a need for a Farm Credit System today, given the tremendous number of banks that exist which didn't exist when we had the Farm Credit System starting up? The fact of the matter is we have a Farm Credit System now and we have tremendous debt outstanding, and so what do we do about it?

One thing is to just make a better Farm Credit System trying to back up the loans that have been made and try to insure future good loans. Another approach might be to attempt to subsume the Farm Credit System in some way into our total financial service delivery system.

Is that something that is even worthy of pursuit—to try to stop the hemorrhaging but not in a way that is going to keep the Farm Credit System around forever? Is it necessary to have the Farm Credit System, given the financial service delivery system in effect in the United States today as opposed to the thirties?

Mr. BERGLAND. I think it is, but I would like to yield to Mr. Cline who deals with it every day.

Mr. CLINE. Thank you, sir.

I realize that I am talking about my competition when I talk about PCAs and land banks, but I feel there is a place for the Farm Credit System in industry today. Competition makes for a good situation. The Farm Credit System is able to tap money markets that commercial banks in my area cannot tap, so it is able to bring in money into my area from New York, from Wall Street, wherever you want to say, that is not available if the Federal land banks and the PCAs did not have an organization in my county.

I think there is definitely a place for the Farm Credit System and the commercial bank lenders. The reason I think there is a need to try to save the commercial banking industry and the Farm Credit System is these organizations loan money to producers who produce food and fiber for our country. I can do without a Chrysler automobile. I can do without many other things, but I cannot do without food, and we must save those producers that are producing the food for our country, and to do this, we have to work to see that they have a profitable operation and that they have money available to produce that crop.

Chairman LAFALCE. Isn't the problem over production today and low price?

Mr. CLINE. That is part of the problem, but not all of it.

Mr. FRAZIER. But the answer isn't to wipe out all the independent operators and turn it over to a foreign investor and a bunch of hired hands. We don't want that kind of a system throughout the United States. That is not why we are in Washington.

Chairman LAFALCE. Let's assume that we make the judgment that it is an appropriate socioeconomic purpose for the Federal Government to give financial assistance in the range of $3, $4, whatever billion under the discretion of the Secretary under certain circumstances and conditions.

Now, what should these circumstances and conditions be? When we considered the Chrysler loan guarantee bill, I wrote a dissenting opinion in committee. I said I disagree with some of my colleagues who are philosophically opposed to assistance from the Government to the private sector, but I also disagree with some of my colleagues who are willing to give financial assistance without a quid pro quo.

At the time the bill was considered in subcommittee and committee, it was my judgment that quid pro quos were not written into the bill although they were written into the conference report, and I was able to support the conference report.

Assuming that the disposition of the Congress is the same that there ought to be a demand for a quid pro quo, shared sacrifices in Chrysler, we required labor, the stockholders, the creditors, et cetera, to take a hit.

Everybody that we were helping we required that they take a hit for a number of reasons, one of which was so that you wouldn't have a precedent where people think they can get into trouble and then be saved without having to sacrifice.

Who would be the parties that we would be helping here, and how should we most appropriately require them to take a hit without killing the patient? We want to save the patients. That is the purpose of it. We want them to take some medicine, know they had to take medicine, but to save them, not to kill them.

Is there some guidance you could give, some criteria you could suggest?

Mr. Frazier. Several have spoken of one issue. For example, if you are to extend some form of assistance to private banks on some of their loans, we would expect them to revalue that land at today's current value and swallow the loss before moving it into a different inventory on a refinancing arrangement. This is just one example in which we have already acknowledged that there is a responsibility on their part.

Mr. Mullins. Following up on what was just said, I think that is one way that you say you are going to have to feel a little hurt. Your local land bank if he is going to be able to move that troubled loan or move some of that land he has in inventory into some sort of a capital corporation, they should—as recommended here, they should be required to absorb part of that loss out of their reserves so they know that it is going to hurt.

Chairman LaFalce. What are the reserves right now?

Mr. Mullins. What I am talking about is the member equity in the local land bank. So it is coming out of the pocket of farmers.

Chairman LaFalce. Shouldn't we be able to look at the totality of the land banks?

Mr. Mullins. Yes.

Chairman LaFalce. When would we need legislative changes in order to look at the whole?

Mr. Vento. Would the chairman yield?

That gets to one of my questions. In other words, if that equity that the farmers have in their percentage of the loan or whatever they borrow it is in the Farm Credit System in their regional bank I guess, wouldn't that have a negative effect in terms of their future participation? I mean these generally are going to be the farmers that are paying back their loans.

These are basically the good credit risks that are in the credit system. The ones bad, you just keep what they have in there, I guess. Isn't that going to really be a problem? I guess I don't know how exactly it is going to play out. I am trying to get a reaction from you. It is like the healthy farmers, the bank paying out the ones that are healthy paying for the loans that are not healthy, and we are saying we are going to squeeze it out of them, it is not a problem.

Mr. Mullins. It is a problem, but I don't have an answer. But to a large degree the good borrowers who can are bailing out of the System.

Mr. Vento. Why would they stay, they would take their money with them and whatever their participating value is and leave.

Mr. Mullins. You take that a step further in shoring up the System——

Mr. Vento. They are like the First Bank system, 30 of them selling out for the healthy banks.

Mr. Mullins. If you shore up the system at some point where the interest rate charged by the local land bank is competitive with or below the commercial bank, then you have a viable system and your good borrowers——

Mr. **Vento**. That is another problem in terms of the bond cost. I am on my chairman's time now.

Mr. **Cline**. One comment, you see the difference between stocks in a Federal land bank or PCA versus a commercial bank on that order. Commercial bank stockholders purchase the stock and intend to make money and draw a dividend. I think the stock that is in the Farm Credit System should not be touched. I agree that the earned surplus reserve for bad debts, that the stockholders never anticipated getting a dividend, never anticipated getting that money should be used in case of losses exactly what it was set aside for.

Mr. **Vento**. But if they drop out of the participation in the Federal credit system they can take the chips with them.

Chairman **LaFalce**. Why not the stock, Mr. Cline?

Mr. **Cline**. I think the stock was purchased for a different purpose.

Chairman **LaFalce**. Purchased for a different purpose maybe, but it is the member borrower stock. He is participating basically in an insurance pool, and shouldn't he have to participate at least in some loss before you ask the taxpayer to experience some loss? That is what it comes down to.

The taxpayer is going to have to experience some loss. Before all the taxpayers experience some loss, shouldn't you require that the member borrowers experience some loss?

Mr. **Cline**. Hopefully, the Farm Credit System will be able to work out of this situation with a time period and there will be no cost to the Government or to the taxpayer.

Chairman **LaFalce**. I am saying before you draw down on any loan or loan guarantee, shouldn't one of the requirements be that you first have some drawdown on member borrower stock?

Mr. **Cline**. I still feel that the earned surpluses should be used.

Chairman **LaFalce**. Before the member borrower stock?

Mr. **Cline**. Yes.

Chairman **LaFalce**. But between drawing down on your reserves and drawing down on the Treasury's money that we would have to vote, what about member borrower stock?

Mr. Bereuter.

Mr. **Bereuter**. I have two quick questions that can probably be answered yes or no.

The Farm Credit System has created a financial warehouse for bad loans. One, do you think it is a good idea; two, do you think if it is a good idea should we have a larger structure created that would also take bad loans from commercial banks and from the Farmers Home Loan Administration? How about the first part of the question?

Mr. **Bergland**. Mr. Bereuter, I think it is a good idea. I can't comment on the commercial bank section of your question. I don't know. I believe the FHA ought to continue to be a lender of last resort.

Mr. **Bereuter**. The next gentleman?

Mr. **Frazier**. I think the larger approach will be found necessary or worthwhile over the next 2 or 3 years.

Mr. **Mullins**. I think it is a good idea in the package and I believe it should be expanded.

Mr. **Senter**. The warehouse is much better than immediately liquidating, which is going to force land down further.

Mr. **Bereuter**. Should it be expanded to commercial banks also?

Mr. **Senter**. Yes.

Mr. **Cline**. I think it is a good idea. I don't see need for FmHA to be expanded into it but I think there is a need for expansion into the commercial banking industry.

Mr. **Bereuter**. Has the Farm Credit System changed its policy regarding forbearance with regard to foreclosures? Do you discern, in other words, a change regarding this in recent months? Has there been increased effort to accelerated collection of loans and increase sale of acquired property—is there a change that you have noticed?

Mr. **Bergland**. I have not seen reports, but according to what we hear there has been an acceleration of foreclosures and volunteer liquidations. I don't know about property disposal.

Mr. **Frazier**. My board of directors last week were telling me of accelerated action at the local level. In absence of action by the Congress, it will get very tough before next spring.

Mr. **Mullins**. My people say the same thing.

Mr. **Senter**. Yes, increased action.

Mr. **Cline**. Increased action in agriculture and lending institutions and that is because of the shaky condition of agriculture in this country of ours.

Mr. **Bereuter**. It has been my conclusion that you are right and that saving the system has become more important in some instances than saving the individual farmers and borrowers, and that is very unfortunate, a very undesirable situation that is underway in that respect.

I would ask, Mr. Chairman, unanimous consent that the chart regarding who owns and who buys the securities might be made a part of the hearing record.

Chairman **LaFalce**. Without objection, so ordered.

[The chart follows:]

Federal Farm Credit Banks
Funding Corporation

PERCENTAGE BREAKDOWN OF PURCHASERS OF FARM CREDIT SECURITIES

INVESTOR CATEGORY	1984	1982
Commercial Banks		
Portfolio	30	29
Trust	11	11
Investment Advisory & Trading	4	5
State & Local Governments	15	13
Mutual, Money Market and Investment Funds	9	10
Foreign Purchasers	12	9
Thrift Institutions	6	6
Pension Funds	2	5
Insurance Companies	2	3
Non-Financial Corporations	4	3
Individuals	3	3
Fraternal, Charitable & Educational	1	2
Other Dealers	1	1
TOTAL	100%	100%

Source: Quarterly Distribution Reports submitted by selected Selling Group members which detail primary sales of Farm Credit securities. For the purpose of this analysis, selected six and nine month and term issues were used.

MS/7/84

Chairman **LaFalce**. The subcommittee wants to thank every member of the panel for their testimony and for their excellent responses to the questions of the subcommittee. This coming Thursday, we will hear witnesses from the Federal Reserve System, the Office of the Comptroller of the Currency, from the Federal Deposit Insurance Corporation, and the General Accounting Office. The subcommittee is adjourned until that time.

[Whereupon, at 4:35 p.m., the subcommittee adjourned, to reconvene at 3 p.m. on Thursday, Nov. 21, 1985.]

[The following material was submitted for inclusion in the record:]

STATEMENT SUBMITTED BY THE NATIONAL COUNCIL OF FARMER COOPERATIVES

The National Council of Farmer Cooperatives is a nationwide association of cooperative businesses which are owned and controlled by farmers. National Council members handle practically every type of agricultural commodity produced in the U.S., market these commodities domestically and around the world, and furnish production supplies and credit to their farmer members and patrons. The National Council represents about 90 percent of the nearly 5,800 local farmer cooperatives in the nation, with a combined membership of nearly 2 million farmers.

These local cooperatives are part of the Farm Credit System in two ways. First, their farmer-owners have borrowed from the System for their operations. Secondly, the cooperatives have borrowed and hold stock in the System.

In 1984, the largest 100 farmer cooperatives had nearly $500 million invested in the Banks for Cooperatives. At the same time over one-half of the $6.4 billion of these cooperatives' debt came from the Banks for Cooperatives. This underscores our basis for concern and support for appropriate and necessary actions to address the financial problems faced by our farmers.

Our primary concern is the financial health of our farmer-members. For if farmers are having problems then cooperatives are having problems. If the Farm Credit System is forced to charge higher interest rates, freeze stock or increase foreclosure rates, then everyone is impacted. The farmer is not only impacted in his own financial arrangements but in his reduced benefits or earnings as a member of the cooperative. Higher interest rates would not only increase the farmers' interest expense, but also reduce his earnings from the cooperatives because of the higher interest charges. The farmer is paying twice.

These are difficult times for farmers and their cooperatives. Few sectors of the economy have experienced such a rapid reversal in economic fortunes as has occurred in agriculture in the 1980's.

But the impacts are not confined only to farmers or their cooperatives. Among the input industries, we find farm machinery plant operations scaled back to less than half of capacity. The fertilizer industry is using less than three-fourth's of its capacity and the transportation, processing and marketing sectors have about one-fifth of their capacity unused. This represents lost jobs and income to the local communities that make up rural America.

There are a number of complicated and related factors which have contributed to the current state of agriculture -- including economic recession, an overvalued dollar, third world debt, unfair trade practices, and past embargoes. But the issue is where do we go from here?

I believe we are making progress. I wish to commend The House of Representatives for its approval of a 1985 Farm Bill. This I believe recognizes the current problems of agriculture and attempts to provide the support necessary to return profitability to farming.

This measure is designed to stabilize the drop in farm income and, hopefully, lay the foundation for future recovery in terms of export markets and farm income. However, in the near term we must recognize the fact that agriculture is experiencing a massive decapitalization. This, in turn, is undermining income stabilization efforts and the viability of the agricultural lending institutions. This leads to a further deterioration in the financial condition of agriculture.

The next 12-24 months will be increasingly difficult for farmers and those providing financing. If land values continue to decline or fall sharply -- the equity of otherwise sound farm operators will be greatly reduced. This could lead to an increase in the size of loan write-offs and the magnitude of the financial problem. Therefore it is essential to restore stability to farmland values and assure credit availability to American agriculture at reasonable rates.

The Farm Credit System, dedicated exclusively to an industry that is facing continued erosion in real income and massive asset devaluation, cannot continue to absorb the financial consequences. The System holds about one-third of the total farm debt and 48 percent of the farm real estate debt. Increasing interest rates to generate earnings in the face of mounting losses will drive farmers who are currently trying to refinance toward bankruptcy at an accelerating rate. For those who can refinance, these same higher rates are driving those farmers to other lenders. Other farmer capital flees the system out of fear that their stock investment will be lost. The result is a downward spiral in the confidence and capital base in the system as a whole. This is true not only for farmers but their cooperatives who depend on the system as a vital source of credit.

For these reasons, the National Council of Farmer Cooperatives supports the proposal of the Farm Credit Council and views it as an integral component of a comprehensive and balanced approach to restoring profit-ability to agriculture.

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THE PROBLEMS OF FARM CREDIT

THURSDAY, NOVEMBER 21, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 3:15 p.m., in room 2128, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce, Representatives Carper, Bereuter, Dreier, and Grotberg.

Also present: Representative Leach.

Chairman LaFalce. Today marks the fifth of our series of hearings on farm credit problems. At previous hearings we have had agricultural economists, administration officials, representatives of the Farm Credit System and its regulatory agency, commercial bankers, and farmer organizations. For today's hearing, we have invited witnesses from various Government agencies familiar with the farm credit situation.

A persistent question raised in our earlier hearings has been how much assistance can be provided the Farm Credit System or agricultural banks under current law? To help us answer that question, we invited a witness from the Federal Reserve to explain the legal authority of the Federal Reserve in this area. How much assistance can it provide? Under what conditions? For how long? With what collateral arrangements?

Our previous hearings have brought out the fact that half of the 100 commercial banks that have closed this year are "ag banks"—those with more than 25 percent of their loans to farmers. We want to learn from the representatives of the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency how they evaluate the risks to the commercial banking system of the problems of farm loans. They testified on this issue before another subcommittee earlier this year, but we asked for an update in light of the serious deterioration we have found for the Farm Credit System in recent quarters.

Representatives of commercial banks lending to farmers have asked for legislation to assist them if the Farm Credit System gets assistance. As the Congress considers that request, it must evaluate whether it is in the national interest. How many people are being hurt directly by the stress among ag banks? How large are the ag banks being forced to close? Do they have ties to other financial institutions such that injury to them could pose a threat to the wider economy?

If the ag banks that are closing are federally insured, their depositors are protected up to $100,000. If those banks are reopened, regular banking services are retained in the community for deposits and borrowing. Of course, bank stockholders and depositors in excess of $100,000 take some loss, but they took that risk voluntarily.

Finally, we have asked the GAO to testify on two issues related to the Farm Credit System. First, we asked them to update their excellent survey of the financial condition of the Farm Credit System which they issued early last month. Second, we asked them to draw some lessons from the legislated rescues of four other large institutions: Chrysler, Conrail, New York, and Lockheed. The General Accounting Office was directly involved in implementing the rescue of Chrysler and Conrail, and issued a report on its lessons early last year.

As the Chrysler legislation was proceeding in 1979, I and many of my colleagues were concerned that we not grant assistance in a way that would encourage a long line of other large corporations to seek similar help. The Chrysler legislation succeeded not only in rescuing that corporation but also in discouraging other corporations from lining up. We should be pleased to read in Lee Iacocca's recent book, "If I'd had the slightest idea of what lay ahead for me when I joined up with Chrysler, I wouldn't have gone over there for all the money in the world."

Now as the Congress considers help for the Farm Credit System, we must bear in mind that many other financial institutions would like to unload their bad loans on the Government. While we must be concerned about the integrity of our financial system, we do not want to reward bad management either.

Our witnesses today are Stephen Axilrod of the Federal Reserve System, Jonathan Fiechter of the Office of the Comptroller of the Currency, David Meadows of the Federal Deposit Insurance Corporation, and Craig Simmons of the General Accounting Office.

Does any Member have a statement that he or she wishes to make? Hearing none we will continue.

Now that some semblance of order has returned to this subcommittee and to this room, let me apologize to the members of the panel for the delay that transpired while you were waiting to testify—if not beyond human control, certainly beyond the control of the subcommittee, as you witness the spectacular event.

However, because it is now almost 3:20 and we were scheduled to begin at 2 p.m., I am going to ask each of you to summarize your remarks, in absolutely no more than 5 minutes. We will put, if there is no objection from any Member of the subcommittee, the entire text of the testimony of each of the witnesses in the record at this point in time. Without objection, so ordered.

Because of time constraints, our first witness will be Mr. Axilrod.

STATEMENT OF STEPHEN H. AXILROD, STAFF DIRECTOR FOR MONETARY AND FINANCIAL POLICY, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. AXILROD. I think my entire text will take that long.

I appreciate the opportunity to appear before this committee to clarify the technical aspects of possible discount window lending by the Federal Reserve to the Farm Credit System, as well as agricultural banks. In doing so, I would point out, first, that no request for credit from the Farm Credit System has been received. The Farm Credit System has considerable strengths. The amount of capital that it can bring to bear on its problems is quite large, and it holds a substantial amount of liquid assets. While the farm credit obligations in the market are currently trading at a considerably wider spread above Treasury debt than was true only a few months ago, that spread has stabilized and even narrowed a bit in recent weeks. The Farm Credit System has continued to be successful in tapping credit markets for needed funds.

In general, the Federal Reserve discount window is intended to be a short-term liquidity facility for use by borrowers—normally limited to depository institutions—when other sources of liquidity are not reasonably available. Borrowers are expected to show that they have made every effort to obtain needed funding from other sources, consistent with the Federal Reserve's role as the "lender of last resort." Within this context, credit is occasionally made available to depository institutions for more extended periods for certain purposes, such as troubled institutions facing sustained liquidity pressures. But the Federal Reserve discount window was not intended to be a facility for long-term financing or to be a substitute for risk-bearing capital. All lending by Federal Reserve banks at the discount window must, by statute, be on a secured basis.

While Federal Reserve lending authority is normally confined to depository institutions, there are exceptions. In the case of the Farm Credit System, the Federal Reserve has long been authorized explicitly in the Federal Reserve Act to lend to one component of that System—the Federal Intermediate Credit Banks—under section 13a of the Federal Reserve Act, which addresses the discount of agricultural paper. Specifically, subsection 2 permits Federal Reserve banks, among other things, to discount notes payable to an FICB, provided the notes have remaining maturities of 9 months or less and are secured by agricultural loans also with 9 months or less to run. The statutory provision does not suggest there need be any special findings to justify such lending, or that the lending decision would be substantially different than for a depository institution. This provision of the act, which was passed in 1923, has not been used since the early part of the 1930's.

I believe that, as a technical matter, funds loaned to FICB's could be passed along to other units within the Farm Credit System. However, the FICB's are only a small component of the System and not all of their collateral would meet the technical requirements of section 13a of the Federal Reserve Act. Additional authority to lend to the Farm Credit System must rest on the other provisions of the Federal Reserve Act that in certain emergency circumstances permit loans to any individual, partnership, or corporation.

Under one of the provisions (section 13.13) such loans can be made with U.S. Government or "Federal agency" securities as collateral. The Farm Credit System holds only a relatively small amount of U.S. Government securities or securities of other Federal agencies to pledge as collateral—which in any event are a portion of their overall liquidity that is likely to be drawn on in case of need, as with other portions of liquidity.

Under another provision of the act (section 13.3) the Federal Reserve could also make funds available on the basis of any collateral provided the lending is "secured to the satisfaction of the Federal Reserve bank." But such loans can be made only in "unusual and exigent circumstances" and require an affirmative vote by five members of the Board.

Clearly, a finding by the Board of Governors that such "unusual and exigent circumstances" exist would require an important policy judgment, including evaluation of the consequences of lending, or not, on the economy generally, prospects for reform of the Farm Credit System and for repayment, as well as other factors. The emergency provisions have been used very rarely and in the case of section 13.3 not at all since the mid-1930's.

Apart from that basic policy decision, there appears to be enough collateral within the Farm Credit System as a whole to back a substantial amount of Federal Reserve lending. By statute, an amount of Farm Credit System assets equivalent to note and bond obligations outstanding must be maintained unencumbered. However, the assets of the System exceed its obligations by several billion dollars. More importantly, in terms of the potential capacity for lending by the Federal Reserve, this pool would grow if and as Farm Credit System bonds were redeemed. Of course, the total amount of lending by the Federal Reserve that could be supported by the available collateral would depend on the appropriate valuation of that collateral at the time of the loan. In addition, in acting as lender of last resort, particularly under emergency provision, the Federal Reserve Board or the lending Reserve Bank would have the opportunity to place such restrictions on the use of its funds as it considers reasonable and appropriate to safeguard those funds and to facilitate the return of the borrowing institution to financial health.

Apart from lending through the discount window, the Federal Reserve has authority to acquire Farm Credit System securities, as well as other agency securities, in the open market. The authority is provided under different sections of the Federal Reserve Act dealing with open market operations. The Federal Reserve has in the past occasionally purchased farm credit obligations in the market and holds such securities today. But that open market authority is designed to facilitate the conduct of monetary policy, not to deal with the liquidity needs of individual institutions, troubled or not. It is not a substitute for, nor was it intended to substitute for, the loans that would directly provide funds that may be needed by individual borrowers under liquidity pressure, in this case, the Farm Credit System.

Chairman LaFalce. Your time has expired.

[The prepared statement of Mr. Axilrod follows:]

Testimony of

Stephen H. Axilrod

Staff Director for Monetary and Financial Policy

Board of Governors of the Federal Reserve System

before the

Subcommittee on Economic Stabilization

of the

Committee on Banking, Finance, and Urban Affairs

House of Representatives

November 21, 1985

I appreciate the opportunity to appear before this committee to clarify the technical aspects of possible discount window lending by the Federal Reserve to the Farm Credit System, as well as agricultural banks. In doing so, I would point out, first, that no request for credit from the Farm Credit System has been received. The Farm Credit System has considerable strengths. The amount of capital that it can bring to bear on its problems is quite large, and it holds a substantial amount of liquid assets. While the Farm Credit obligations in the market are currently trading at a considerably wider spread above Treasury debt than was true only a few months ago, that spread has stabilized and even narrowed a bit in recent weeks. The Farm Credit System has continued to be successful in tapping credit markets for needed funds.

In general, The Federal Reserve discount window is intended to be a short-term liquidity facility for use by borrowers—normally limited to depository institutions—when other sources of liquidity are not reasonably available. Borrowers are expected to show that they have made every effort to obtain needed funding from other sources, consistent with the Federal Reserve's role as the "lender of last resort". Within this context, credit is occasionally made available to depository institutions for more extended periods for certain purposes, such as troubled institutions facing sustained liquidity pressures. But the Federal Reserve discount window was not intended to be a facility for long-term financing or to be a substitute for risk-bearing capital. All lending by Federal Reserve Banks at the discount window must, by statute, be on a secured basis.

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I believe that, as a technical matter, funds loaned to FICBs could be passed along to other units within the Farm Credit System. However, the FICBs are only a small component of the System and not all of their collateral would meet the technical requirements of section 13a of the Federal Reserve Act. Additional authority to lend to the Farm Credit System must rest on the other provisions of the Federal Reserve Act that in certain emergency circumstances permit loans to any individual, partnership, or corporation.

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Clearly, a finding by the Board of Governors that such "unusual and exigent circumstances" exist would require an important policy judgment, including evaluation of the consequences of lending, or not, on the economy generally, prospects for reform of the Farm Credit System and for repayment, as well as other factors. The emergency provisions have been used very rarely and in the case of section 13.3 not at all since the mid-1930's.

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With regard to agriculturally oriented commercial banks, they have access to the usual discount window facilities at the Federal Reserve that are open to any depository institution holding transactions accounts or nonpersonal time deposits. In addition to ordinary very short-term adjustment credit, the Federal Reserve has a seasonal credit program for smaller depository institutions without ready access to national money markets. This facility is intended in particular to assist agricultural banks, whose seasonal liquidity pressures are likely to be especially strong. Last spring, the Board modified its regular seasonal program to make more funds available and, for the past crop season, established a special temporary program for agricultural banks who might have experienced strong loan demand in the spring and summer. But, in the event, with loan demand relatively light, and the liquidity of most farm banks ample, use of the regular and special seasonal lending facilities was relatively modest. Agricultural banks, like other depository institutions, also have access to other extended credit should that be needed to help them work out of difficult situations entailing sustained liquidity pressures.

Chairman LaFalce. We will go to Mr. Fiechter. Your statement is 14 pages long. I ask you to summarize.

STATEMENT OF JONATHAN L. FIECHTER, DIRECTOR OF ECONOMIC AND POLICY ANALYSIS, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. Fiechter. I appreciate the opportunity to talk to you about the condition of agricultural banks. Based on what you have heard previously, I won't go into the agricultural sector's problems other than to note that it is our belief that the problems are not applicable to all farmers, but rather tend to be concentrated in a minority of farmers who heavily leveraged themselves in the 1970's. I will spend the rest of my time on the condition of national agricultural banks.

The problems experienced by farmers over the last 3 years have had a direct effect on a variety of private and public agricultural lenders. Banks' direct exposure to the agriculture sector is limited to slightly over 2 percent of total commercial bank assets. The entire banking system holds approximately $50 billion in direct loans to the farm sector. Half of the $50 billion in commerical bank credit is held by commercial banks with diversified loan portfolios. The other half of the $50 billion is held by over 3,900 banks that we define as agricultural banks; that is, having more than 25 percent of their loans in agricultural credits.

These agricultural banks are typically relatively small. They have average assets of about $30 million. While they comprise about 27 percent of the commercial bank populations, they hold less than 5 percent of the total commerical bank assets. About 850 of these banks are national agricultural banks. The majority of the agricultural banks are State-chartered.

Primarily as a result of the growing credit quality problems with farm loans, the condition of national agricultural banks has deteriorated. An increasing proportion of national agricultural banks are problem banks, that is, have CAMEL ratings of 4 or 5. In mid-1983, 18 percent of problem national banks were agricultural banks. However, as of June of this year, agricultural banks accounted for 37 percent of problem national banks. This increase in the number of problem national agricultural banks accounts for most of the increase in the number of problem national banks over the past few years. Of the 26 national banks that have failed thus far this year, eight, or about one-third, have been agricultural banks.

However, the problems of many agricultural banks, while serious, must be kept in perspective. The majority of agricultural banks are healthy and viable. The typical agricultural bank, with an average primary capital-to-asset ratio of 10.5 percent, continues to be better capitalized than its nonagricultural counterpart, which has, on average, a 9.5-percent primary capital-to-asset ratio.

This does not diminish the fact that the condition of a number of agricultural banks is poor and requires serious supervisory attention. We recognize the cost to a local community of bank failure. However, we do not believe that the current number of bank failures nor the problems associated with the agricultural sector currently pose a threat to the confidence in or the stability of the commercial banking system.

Moreover, we do not believe Federal assistance is necessary at this time. We believe targeting assistance to those banks with large agricultural portfolios is undesirable from the point of view of public policy. Such assistance could have longer term detrimental effects on the banking system. Federal assistance could establish a precedent for other economic sectors to seek legislative relief from adverse credit conditions. Banks that have extended credit to the energy industry, timber industry and commercial real estate developers, for example, might seek similar legislative relief.

Such assistance would also inadvertently penalize those agricultural banks that have already marked down their loan portfolios and taken the brunt of their losses. Furthermore, it would send the wrong signal to the majority of agricultural banks that are successfully coping with the problems of the farm sector. Their incentives for carefully working their way out of problems would likely be diminished if there was a promise of Government help.

In conclusion, the deteriorating condition of many agricultural banks is a result of structural changes within the Nation's farm sector. It may be unrealistic to view those changes as temporary in nature or to expect asset values and commodity prices to return to the levels of the late 1970's. Resolution of the agricultural bank problem, therefore, is dependent upon farmers and farm lenders adjusting to the structural changes in the agricultural sector. We are confident that through the current efforts of the banks, their borrowers and supervisors, the problems currently facing agricultural banks will continue to be manageable.

Thank you.

[The prepared statement of Mr. Fiechter follows:]

STATEMENT OF
JONATHAN L. FIECHTER
DIRECTOR OF ECONOMIC AND POLICY ANALYSIS
OFFICE OF THE COMPTROLLER OF THE CURRENCY
Before the
SUBCOMMITTEE ON ECONOMIC STABILIZATION
of the
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

November 21, 1985

Mr. Chairman, members of the Subcommittee, I appreciate the opportunity to talk to you about the condition of agricultural banks. As you are well aware, our agricultural sector is going through a difficult period and the problems experienced by farm borrowers over the last few years have had a direct effect on agricultural lenders. Both federal and private lenders have experienced a dramatic increase in the number of problem agricultural loans. We believe, however, that the credit quality problems currently facing agricultural banks are manageable and do not threaten the safety and soundness of the national banking system.

THE AGRICULTURE SECTOR'S PROBLEMS

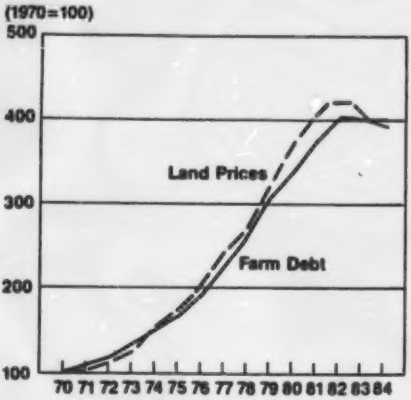
American agriculture is going through a difficult period. However, the problems are not universal among farmers. The problems of the agricultural sector are generally concentrated among farmers who highly leveraged themselves in the 1970s.

In the previous decade, the Nation's farm sector enjoyed expanded production. Domestic sales grew steadily at an average annual rate of almost 9 percent. Exports increased almost 19 percent annually in response to a weak dollar and foreign production shortfalls. As a result of this growth, farm revenue expanded at an annual rate of 10 percent.

The improved income of farmers during the 1970s boosted expected returns on farm assets, and drove up land values. The enhanced net worth of farmers, combined with optimistic expectations of further increases in farmland and commodity prices, prompted many farmers to borrow heavily to expand. In many cases, heavy borrowing took place despite sluggish growth in cash flow. As shown in Chart 1, between 1970 and 1981, both farm debt and the price of farm land quadrupled.

Chart 1

Farm Debt and Farmland Prices

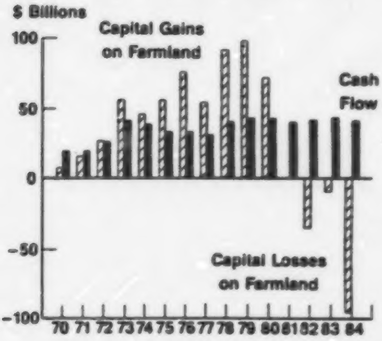


Farm Debt excludes farm households
Source: USDA, Federal Reserve

Beginning in the early 1980s, however, it became clear that earlier expectations about the strength of the farm economy would not be realized. The worldwide recession, an appreciating dollar, and the export policies of competing countries all contributed to a decline in agricultural exports. Furthermore, stagnant commodity prices, high real interest rates, and increased production costs led to a deterioration in farm profitability and diminished cash flow. As shown in Chart 2, as the expected returns on farming declined in the 1980s, the value of farmland also began to fall.

Chart 2

Farm Cash Flow and Capital Gains



Cash flow after interest & taxes less additions to inventory (excludes farm households)

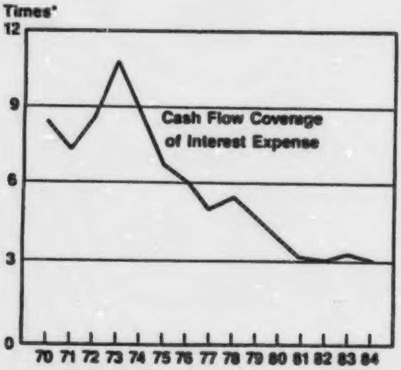
Source: USDA, Federal Reserve

Most farmers, despite a less robust agricultural environment, have generally been able to meet their debt servicing requirements. According to Federal Reserve Board analysis of a 1985 USDA Survey of Farm Costs and Returns, presented in recent testimony before this Subcommittee, 70 percent of commercial farm operators are considered to be in "good" financial condition. That is, 70 percent of these farmers have a favorable combination of income and equity cushion.

A minority of farmers, however, who heavily leveraged themselves in the 1970s, have inadequate cash flow to meet their higher debt servicing requirements. As can be seen in Chart 3, debt servicing capacity declined considerably over the 1970s. By 1984, cash flow coverage of interest expense was one-third of what it was a decade earlier. The result has been a deterioration in farm credit quality, particularly for highly leveraged farmers.

Chart 3

Debt Servicing Capacity of Farmers



*Cash Flow before interest less additions to inventory/interest expense (excludes farm households)

Source: USDA, Federal Reserve

According to USDA data of January 1985, farmers with debt-to-asset ratios in excess of 40 percent represent less than one third of all farms, but owe almost two thirds of all farm debt. The significant rise in problem agricultural loans and farm bankruptcies can be attributed primarily to this group of farmers.

These financial problems appear to be concentrated among mid-sized farms, those with annual sales of between $40,000 and $500,000. Many of these farms have experienced several consecutive years of operating losses making debt repayment difficult, especially for those that became overextended in the 1970s.

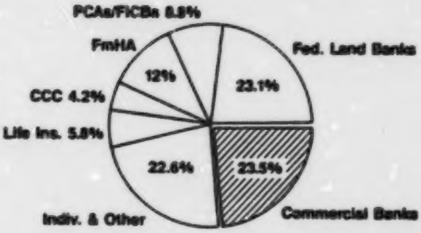
COMMERCIAL BANK EXPOSURE TO THE FARM CREDIT PROBLEM

The problems experienced by farm borrowers over the last few years have had a direct effect on a variety of private and public agricultural lenders. We do not believe, however, that problems in the agricultural sector have endangered the safety and soundness of the banking system.

The banking sector's direct exposure to the agriculture sector is limited to slightly over 2 percent of total commercial bank assets. As shown in Chart 4, the banking system holds approximately $50 billion in direct loans to the farm sector, which is roughly one-fourth of the total farm debt.

Chart 4

Holders of Farm Credit



($213 Billion)

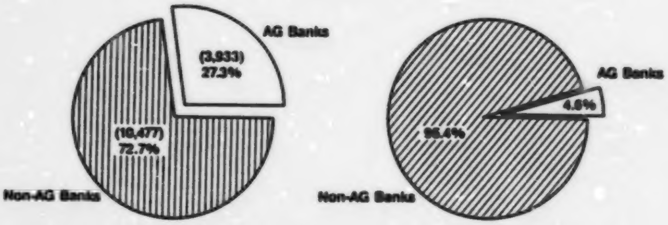
Source: Federal Reserve, December 1984

Half of the $50 billion in commercial bank credit to the farm sector is held by commercial banks with diversified loan portfolios. These include small banks that do little agricultural lending as well as large banks that have sizable agricultural loan portfolios but also lend in other areas. Because these banks are diversified, they are generally able to absorb the losses attributed to the deteriorating condition of agricultural credits.

The other half of the agricultural credit extended by the commercial banking system is held by 3,900 agricultural banks, defined as banks with over 25 percent of their gross loans in agricultural credits. Agricultural banks have average assets of about $30 million and are typically much smaller than non-agricultural banks. As seen in Chart 5 below, while they comprise 27 percent of the commercial bank population, they hold less than 5 percent of the total $2.6 trillion in bank assets. These banks, 850 of which are national banks, have been the most susceptible to problems in the agricultural industry.

Chart 5

Number and Total Assets of Agricultural Banks



(14,410 Insured Commercial Banks) ($2,560Bn in Total Assets)

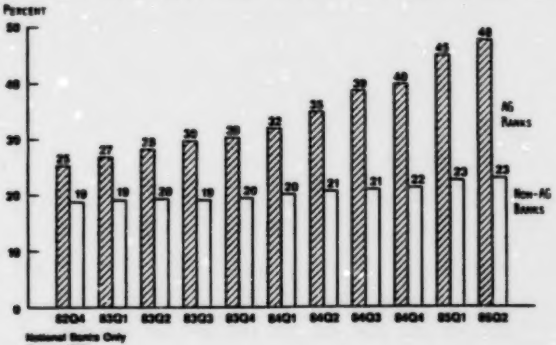
Source: June 1985 Call Reports

Primarily as a result of the growing credit quality problems with farm loans, the condition of national agricultural banks has deteriorated. An increasing proportion of national agricultural banks are problem banks (i.e., have CAMEL ratings of 4 or 5). In mid-1983, 18 percent of problem national banks were agricultural banks. However, as of June of this year, agricultural banks accounted for 37 percent of problem national banks. This increase in the number of problem national agricultural banks accounts for most of the increase in the number of problem national banks over the past few years. Of the 26 national banks that have failed thus far this year, eight, or about one third, have been agricultural banks.

As of June 1985, 157 national agricultural banks reported negative net income as problem loans continued to rise. As shown in Chart 6, national agricultural banks' ratio of median classified assets to gross capital funds reached 48 percent in June of this year. This was up from 35 percent 1 year ago and 28 percent 2 years ago. In contrast, the ratio for non-agricultural national banks has risen only slightly over the past two years from 20 percent in mid-1983 to 23 percent in mid-1985.

Chart 6

Ratio of Median Classified Assets to Gross Capital Funds



National Banks Only
Source: OCC

Furthermore, net loan losses, as a percentage of gross loans, have been rising for each of the past 5 years. In 1979, median net loan losses were less than .25 percent of gross loans. As of year-end 1984, however, median net loan losses as a percentage of total loans had risen to .75 percent.

The problems of many agricultural banks, while serious, must be kept in perspective. The majority of agricultural banks are healthy and viable. The typical agricultural bank, with an average primary capital-to-asset ratio of 10.5 percent, continues to be better capitalized than its non-agricultural counterpart, which has, on average, a 9.5 percent primary capital-to-asset ratio.

This does not diminish the fact that the condition of a number of agricultural banks is poor and requires serious supervisory attention. We recognize the costs to a local community of any bank failure. However, we do not believe that the current number of bank failures nor the problems associated with the agricultural sector currently pose a threat to the confidence in, or the stability of, the commercial banking system.

FEDERAL POLICY REGARDING FARM CREDIT PROBLEMS AT NATIONAL BANKS

A number of the proposals addressing the agricultural situation have suggested financial and other assistance for agricultural lenders including commercial banks. We do not believe that federal assistance for commercial agricultural banks is necessary at this time. We believe that targeting assistance to those banks with large agricultural loan portfolios is undesirable from the point of view of public policy.

First, the assets of agricultural banks in difficulty are not a significant portion of the banking system. Moreover, the majority of these banks are in sound financial condition.

Second, we are confident that the problems facing national agricultural banks are manageable through standard supervisory techniques. To evaluate the condition of individual institutions, we examine loan portfolios and classify loans when it appears that repayment of the loan will require careful attention from bank management. Additionally, through examinations we evaluate the adequacy of management's systems and controls and identify areas of management weakness.

Through special training for examiners who deal primarily with agricultural banks and through quality control procedures that ensure consistency of the evaluation of agricultural credits, we have enhanced our ability to accurately assess the condition of agricultural banks. We have not, however, adopted any special examination procedures to treat problem agricultural loans any differently than other loans. Such measures would lead to financial statements and earnings reports that present a distorted picture of the bank's performance and health, in direct conflict with our primary mission of ensuring systemic stability.

Third, agricultural bankers, with the support and encouragement of their supervisors, are pursuing work-out plans in an effort to resolve their farm borrowers' financial problems. For example, when a lender and farm borrower in financial difficulty expect that there will ultimately be sufficient revenues to repay an outstanding debt, the debt may be restructured and additional credit extended to facilitate a return to profitability. While this in itself will not remove a particular loan from classified status, we believe such work-out strategies represent a prudent banking practice when based on realistic projections of the farmer's ability to generate income. Satisfactory adherence to the restructured schedule will result in loans being removed from problem status.

Finally, we feel that such assistance could have longer-term detrimental effects on the banking system. Federal assistance could establish a precedent for other economic sectors to seek legislative relief from adverse credit conditions. Banks that have extended credit to the energy industry, the timber industry, and commercial real estate developers, for example, might seek similar legislative relief.

Such assistance would also inadvertently penalize those agricultural banks that have already marked down their loan portfolios and taken the brunt of their losses. Furthermore, it would send the wrong signal to the majority of agricultural banks that are successfully coping with the problems of the farm sector. Their incentives for carefully working their way out of problems would likely be diminished if there was a promise of government help.

CONCLUSION

The deteriorating condition of many agricultural banks is a result of structural changes within the nation's farm sector. It may be unrealistic to view those changes as temporary in nature and to expect asset values and commodity prices to return to the levels of the late 1970s in light of a number of developments, including a dramatic slowdown in inflation and the increased productive capacity of a number of foreign countries. The decline in farm land values reflects market pressure to restore asset values to a level that can be supported by the land's ability to generate income.

Resolution of the agricultural bank problem, therefore, is dependent upon farmers and farm lenders adjusting to the structural changes in the agricultural sector. Farm borrowers and banks are currently working together to reach mutually agreeable solutions to loan repayment difficulties. We are confident that through the current efforts of the banks, their borrowers, and their supervisors, the problems currently facing agricultural banks will continue to be manageable.

Chairman LaFalce. Thank you very much, Mr. Fiechter.

Mr. Meadows.

STATEMENT OF A. DAVID MEADOWS, ASSOCIATE DIRECTOR, DIVISION OF BANK SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Meadows. Thank you, Mr. Chairman, and members of the subcommittee.

I appreciate the opportunity to discuss with you the FDIC views on problems being experienced by agricultural banks.

An agricultural bank is defined as one in which agricultural loans comprise 25 percent or more of total loans. As of June 30, 1985, there were about 4,000 such banks.

Historically agricultural banks as a group have enjoyed higher earnings, higher capital levels and lower loan losses. This has changed. While capital remains at high levels, dramatic increases in loan losses have resulted in a decline in profitability for agricultural banks. This will result in safety and soundness problems, if it continues for an extended period of time.

The FDIC has handled a record number of bank failures this year; approximately half of the 100-plus failures have been agricultural banks. The number of problem banks continues to increase and 37 percent of the 1,100 or so problems are considered to be agricultural. Low commodity prices, high production costs, and declining collateral values are indicative of a higher than normal level of risk for both the farmer and the lender.

Despite the problems in the agricultural industry, most agricultural banks are coping with the situation and remain sound institutions. We do not believe that there is a systemwide farm bank crisis. The FDIC has been able to manage the record number of failures and our insurance fund continues to increase. It is clear, however, that agricultural problems and bank failures will increase over time, if the farm economy continues in its weakened condition for an extended period.

I will be happy to answer any questions related to the condition of agricultural banks.

[The prepared statement of Mr. Meadows follows:]

STATEMENT ON

FINANCIAL PROBLEMS FOR FARM LENDERS

PRESENTED TO

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

BY

A. DAVID MEADOWS
ASSOCIATE DIRECTOR
DIVISION OF BANK SUPERVISION
FEDERAL DEPOSIT INSURANCE CORPORATION

November 21, 1985

2220 Rayburn House Office Building
Washington, D.C.

Mr. Chairman, and members of the subcommittee, I appreciate the opportunity to discuss with you the current agricultural situation and its implications for insured commercial banks engaged primarily in servicing agricultural areas. My statement will be brief, summarizing the present condition of agricultural banks.

In previous testimony the FDIC has noted that, as a group, agricultural banks were not in worse condition than the banking industry as a whole -- in fact, they were stronger in some areas, such as capital, than the rest of the industry. In addition, we noted that in spite of record numbers of failures, of both agricultural banks and other banks, we have yet to see an agricultural bank fail solely because of the condition of the agricultural economy. These generalities are still true but the problems in the agricultural economy are increasingly permeating the agricultural banks. While agricultural banks overall are still sound, the number of individual banks with problems is increasing and short of a dramatic and unexpected recovery of the agricultural economy, deterioration within the agricultural banking sector can be expected to continue.

Even though further deterioration is expected, we do not foresee a major crisis that would affect the safety and soundness of all agricultural banks regardless of their present condition and management abilities. The FDIC believes that agricultural banks do not represent a threat to the banking system as a whole.

We define an agricultural bank as one in which agricultural loans comprise 25 percent or more of total loans. Agricultural loans are defined as loans secured by farm land, loans to finance agricultural production and other loans to farmers. As of June 30, there were 3,983 agricultural banks. These banks represent 27 percent of all banks, however, just 5.5 percent of total bank deposits. Agricultural banks operate in 37 states but 61 percent of these banks are in Iowa, Illinois, Kansas, Minnesota, Nebraska and Missouri. These are among 16 Midwest and Plains States which contain 84 percent of the Nation's agricultural banks and 85 percent of agricultural loans made by commercial banks. As of year-end 1984, total farm credit reported by the Department of Agriculture was $190 billion. Commercial banks provide about 25 percent of this credit comprising about 43 percent of the non real estate portion of farm credit. The Farm Credit System accounts for roughly 33 percent of total farm credit, the Farmers Home Administration has about 12 percent, life insurance companies have about six percent, and the remaining 24 percent comes largely from individuals.

It is useful to compare the performance of agricultural banks with nonagricultural banks. Historically, agricultural banks as a group have enjoyed higher earnings, higher capital levels, and lower loan losses. A traditional measure of earnings performance is the return on assets (i.e., net income divided by assets). As a group, agricultural banks began this decade with high returns -- 1.7 percent at midyear 1981, compared to 1.2 percent for nonagricultural banks. Returns have dropped for both groups each subsequent year but the decline has been much greater for agricultural banks. At midyear 1985, a comparison among banks under $100 million in assets showed the average annualized return on assets for agricultural banks was 0.72 percent, slightly less than the return of 0.84

percent earned by nonagricultural banks. These are comparable returns and well-above problem levels but obviously the rapid decline in the profitability of agricultural banks will result in safety and soundness problems if it continues for an extended period of time.

The primary source of a bank's earnings is the spread between the interest it earns on loans and investments and the interest it pays for funds (i.e., net interest income). This source of earnings has been roughly the same for both agricultural and nonagricultural banks through 1983, but beginning in 1984 and continuing in 1985 there has been a modest decline for agricultural banks which has not occurred in nonagricultural banks. Nevertheless, margins are more or less stable and holding up well in both groups.

The source of earnings problems in agricultural banks, not surprisingly, has been high levels of loan losses and problem loans which require increased expense charges to maintain valuation reserves at reasonable levels. Loan losses are typically measured as a percent of loans. Agricultural banks at midyear 1981 had a ratio of net loan chargeoffs to loans of 0.18 percent -- significantly better than the ratio for nonagricultural banks of 0.29 percent. These ratios have risen for both groups but at a much faster rate for agricultural banks. At midyear 1984 loan losses were running at a rate of 0.84 percent for agricultural banks. This rate had nearly doubled at midyear 1985 to 1.59 percent, compared to 0.69 percent for nonagricultural banks.

The final line of defense against financial problems is a bank's capital. It is comforting that in spite of the obvious problems, agricultural bank capital is, on the whole, reasonably strong. The three Federal bank supervisory agencies earlier this year adopted common capital standards which provide that banks without material problems should maintain capital of at least six percent of assets. Only one percent of agricultural banks were below this level at midyear 1985. In fact, 48 percent had capital ratios in excess of ten percent, and 37 percent had capital between eight and ten percent. The remaining 14 percent of agricultural banks had capital between six and eight percent of assets at midyear 1985.

In summary then, at midyear 1985, agricultural and nonagricultural banks as groups were not in significantly different conditions. Earnings were comparable. Asset problems were more serious at agricultural banks but this weakness was offset by stronger capital levels.

Even though the two groups are comparable as a whole, it would be erroneous to conclude that there is no farm bank problem. Within the agricultural bank group there is a much greater disparity in the condition of individual banks which does not show up when looking at group averages. That is, there are fewer "average" banks within the agricultural groups and a greater number of weak banks offset by a greater number of banks that continue the historical pattern of strong performance. For example, roughly 15 percent of agricultural banks operated at a loss for the first six months of 1985 -- about twice the 7.6 percent level experienced by nonagricultural banks. Since the resources and strengths in good banks cannot be used to correct the weaknesses in other banks, it can be concluded that earnings problems are more serious in agricultural banks than nonagricultural banks.

We have previously indicated that loan problems are the main reason agricultural bank earnings have declined. The disparity is readily apparent when looking at the rate of losses to date in 1985. Among agricultural banks, 37 percent have experienced loan losses in the first half of 1985 at an annualized rate in excess of one percent of loans while only 17 percent of nonagricultural banks had loss rates of that level.

Earlier this month we had the 100th FDIC-insured bank failure in 1985. Of these 100, 50 met our definition of an agricultural bank. These 50 banks had aggregate assets of approximately $871 million or an average of $17 million each. The average size of nonagricultural commercial banks that have failed in 1985 was $42 million or roughly two and one-half times larger than the average agricultural bank. Since agricultural banks number only 27 percent of total banks, the rate of failure among agricultural banks is clearly higher than among nonagricultural banks. While problems within the agricultural economy obviously contributed to this failure rate, we have yet to see a bank failure which can be solely attributed to these economic problems. Rather, what has happened to date is that weak lending policies and procedures made the banks vulnerable to external problems and the managements that fostered weak practices have been incapable of correcting the resulting problems.

What can we expect in the near future? Presently there are 1,100 banks considered problems by the FDIC. Of these, 413 or 37 percent are agricultural banks. In the 16 states accounting for 85 percent of agricultural loans carried by commercial banks, 8.5 percent of the banks are currently considered problem institutions by the FDIC. This is only slightly higher than the ratio of 7.5

percent for the country as a whole. Asset quality problems are becoming more pervasive within the agricultural bank community. As of midyear 32 percent of agricultural banks had nonperforming assets (past due, renegotiated and nonaccrual loans) greater than five percent of total assets. Only 15 percent of nonagricultural banks had ratios of nonperforming assets at that level. These loans are not all potential losses but it is reasonable to expect that agricultural banks will continue to suffer significantly higher levels of loan losses than the industry as a whole.

It should not be assumed that 413 problem banks today imply 413 failures in the near future. Only a small percentage of problem banks ultimately fail. For example, there were 642 problem banks as of December 31, 1983. During 1984, 502 banks were added to the problem list, 79 banks failed and 217 banks were removed from the problem list because of improved condition.

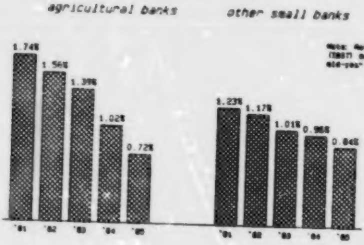
One of the common recurring problems among farmer borrowers is that their total debt has grown over a period of years to a level that is beyond their capacity to service from farm income. Interest rates have come down from the recent past but remain at high levels. Crop prices are low and projected good harvests this year could depress these prices further. Lower farming returns and increasing supplies of land and equipment on the market could cause a continuation of the decline in loan collateral values. Until there is some indication that these basic adverse trends have bottomed out, farmer borrowers will continue to have credit problems. Those banks whose primary business is concentrated in farm loans can be expected to suffer as well and some will fail. We do not expect any improvement in the number of failed agricultural banks during 1986 and there could be an increase.

Nevertheless, I want to emphasize that most agricultural banks are coping well with their problems and remain sound institutions. The FDIC does not believe there is yet a systemwide crisis in agricultural-based commercial banks. However, it is plain that problems in these banks over time will become less a result of different management abilities and more systemic if the agricultural economy continues in its weakened condition for an extended number of years.

Attached are schedules showing past and current performance characteristics of agricultural and nonagricultural banks in 16 Midwest and Plains States containing over three-fourths of the Nation's agricultural banks. Several graphs comparing performance characteristics of all agricultural banks with nonagricultural banks are also included.

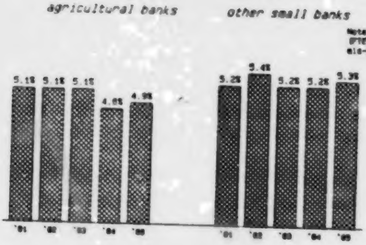
Chart 1 - Mid-Year Call Report Data for Banks with Less than $100 Million in Assets

Return on Assets



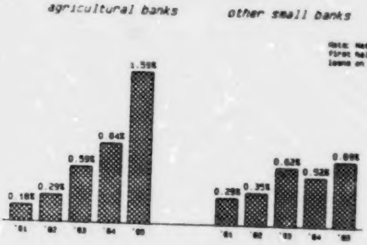
Note: Return on Assets - net operating income [illegible] during first half of year as a percent of mid-year assets on an annualized basis.

Net Interest Margin



Note: Net Interest Margin - net interest income (FTE) during first half of year as a percent of mid-year earning assets on an annualized basis.

Net Loan Losses



Note: Net Loan Losses - net chargeoffs during first half of year as a percent of mid-year loans on an annualized basis.

AGRICULTURAL STATES SUMMARY

	---- AGRICULTURAL BANKS ----					-- NON-AGRICULTURAL BANKS --				
COLORADO	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	3.1	4.5	5.8	NA	NA	2.8	3.0	3.3
CAPITAL RATIO	10.3	10.7	10.3	10.1	10.7	9.7	9.4	9.0	8.8	9.1
LOANS/ASSETS	57.4	56.9	57.8	58.6	57.2	57.5	58.8	57.9	60.2	62.1
ROA	1.6	1.4	1.3	0.9	0.8	1.6	1.3	1.2	1.1	1.0
NIM	6.7	6.5	6.0	5.9	5.6	7.9	7.7	7.0	7.0	6.6

	---- AGRICULTURAL BANKS ----					-- NON-AGRICULTURAL BANKS --				
IOWA	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.7	3.6	4.6	NA	NA	2.8	2.8	3.4
CAPITAL RATIO	9.4	9.5	9.8	10.0	10.3	8.4	8.3	8.3	8.5	8.7
LOANS/ASSETS	52.0	49.1	47.5	48.4	48.9	52.4	50.2	48.9	52.5	53.9
ROA	1.3	1.2	1.2	0.8	0.8	1.0	0.8	0.7	0.7	0.7
NIM	5.1	4.9	4.9	4.6	4.7	4.9	4.8	4.7	4.7	4.8

	---- AGRICULTURAL BANKS ----					-- NON-AGRICULTURAL BANKS --				
IDAHO	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.7	3.3	4.4	NA	NA	2.6	3.1	3.4
CAPITAL RATIO	8.5	8.8	9.0	8.6	9.1	8.3	7.7	7.4	7.2	7.4
LOANS/ASSETS	58.6	59.7	61.2	61.8	63.8	57.8	61.1	61.4	64.6	67.0
ROA	1.2	1.1	1.0	0.7	0.9	0.4	0.4	0.7	0.7	0.3
NIM	6.2	6.4	6.1	5.4	5.2	5.6	5.6	5.5	5.1	4.8

	---- AGRICULTURAL BANKS ----					-- NON-AGRICULTURAL BANKS --				
ILLINOIS	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.5	2.9	3.8	NA	NA	2.7	2.5	2.7
CAPITAL RATIO	9.6	9.7	9.9	10.0	10.2	8.4	8.3	8.2	8.3	8.5
LOANS/ASSETS	49.1	46.5	45.1	47.2	46.9	51.0	48.8	47.4	48.8	49.8
ROA	1.2	1.1	1.1	0.9	1.1	0.8	0.8	0.9	0.9	1.1
NIM	4.9	4.9	4.9	4.7	4.9	4.7	4.8	4.8	4.8	5.0

	---- AGRICULTURAL BANKS ----					-- NON-AGRICULTURAL BANKS --				
INDIANA	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.4	2.8	3.2	NA	NA	2.2	2.1	2.3
CAPITAL RATIO	9.7	9.6	9.5	9.6	9.7	8.5	8.4	8.2	8.4	8.5
LOANS/ASSETS	54.5	52.6	51.0	53.2	52.5	55.2	54.1	51.6	52.9	54.1
ROA	1.0	0.8	0.8	0.8	1.0	0.7	0.6	0.8	0.8	1.0
NIM	4.5	4.4	4.5	4.5	4.8	4.4	4.3	4.4	4.5	4.7

	---- AGRICULTURAL BANKS ----					-- NON-AGRICULTURAL BANKS --				
KANSAS	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.1	3.0	3.9	NA	NA	2.2	2.3	2.6
CAPITAL RATIO	9.3	9.5	9.7	9.7	10.2	8.6	8.6	8.6	8.5	8.9
LOANS/ASSETS	51.2	50.6	50.8	51.9	51.8	51.6	50.8	51.0	53.3	54.2
ROA	1.4	1.3	1.1	0.8	0.9	1.0	1.0	1.0	0.9	1.1
NIM	5.7	5.6	5.4	5.1	5.1	5.4	5.5	5.4	5.1	5.2

	---- AGRICULTURAL BANKS ----					-- NON-AGRICULTURAL BANKS --				
MICHIGAN	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	3.0	3.7	4.0	NA	NA	2.5	2.1	2.2
CAPITAL RATIO	8.8	9.4	9.1	8.3	8.6	8.2	8.1	7.9	8.0	8.1
LOANS/ASSETS	55.1	53.3	54.1	55.7	56.6	56.3	52.8	51.2	53.6	54.5
ROA	0.8	1.0	1.0	0.3	0.7	0.6	0.6	0.7	0.8	0.9
NIM	4.6	5.0	4.7	4.2	4.4	4.6	4.6	4.6	4.7	4.8

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AGRICULTURAL STATES SUMMARY

	AGRICULTURAL BANKS					NON-AGRICULTURAL BANKS				
MINNESOTA	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.7	3.4	5.0	NA	NA	2.7	2.8	3.3
CAPITAL RATIO	9.0	9.2	9.5	9.8	10.1	8.3	8.3	8.1	8.3	8.5
LOANS/ASSETS	54.5	54.1	54.1	55.6	55.9	57.7	57.1	56.3	58.1	59.1
ROA	1.4	1.2	1.1	0.9	1.0	1.0	0.9	1.0	0.9	1.1
NIM	5.4	5.3	5.1	4.9	5.0	5.3	5.3	5.2	5.2	5.3

	AGRICULTURAL BANKS					NON-AGRICULTURAL BANKS				
MISSOURI	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.8	3.9	5.2	NA	NA	2.1	2.1	2.2
CAPITAL RATIO	9.5	9.8	9.6	9.6	10.0	8.5	8.4	8.3	8.3	8.4
LOANS/ASSETS	51.9	50.9	49.7	50.9	50.6	53.3	51.7	51.3	53.1	54.4
ROA	1.3	1.3	1.0	0.6	0.9	1.0	1.0	1.0	0.9	1.0
NIM	5.4	5.4	5.0	4.7	4.8	5.3	5.2	5.0	5.0	5.0

	AGRICULTURAL BANKS					NON-AGRICULTURAL BANKS				
MONTANA	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	3.7	4.7	5.9	NA	NA	3.5	4.0	4.7
CAPITAL RATIO	9.0	9.1	9.3	9.4	9.8	8.4	8.6	8.3	8.3	8.7
LOANS/ASSETS	49.5	49.3	48.2	49.7	50.7	57.2	58.2	58.4	59.0	59.6
ROA	1.5	1.4	1.5	1.1	1.2	1.0	1.1	1.0	1.0	1.0
NIM	5.4	5.6	5.6	5.3	5.2	5.6	6.0	5.9	5.8	5.7

	AGRICULTURAL BANKS					NON-AGRICULTURAL BANKS				
NORTH DAKOTA	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	3.1	3.8	4.8	NA	NA	3.0	3.8	4.1
CAPITAL RATIO	9.2	9.2	9.3	9.6	9.9	8.8	8.4	8.2	8.2	8.9
LOANS/ASSETS	49.0	48.3	47.7	47.9	46.1	54.6	52.8	52.4	52.9	53.4
ROA	1.4	1.2	1.1	1.0	1.3	1.0	1.0	0.7	0.8	1.1
NIM	5.6	5.5	5.1	5.0	5.1	5.3	5.5	5.0	5.0	5.2

	AGRICULTURAL BANKS					NON-AGRICULTURAL BANKS				
NEBRASKA	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.6	3.3	4.2	NA	NA	2.9	3.3	3.7
CAPITAL RATIO	9.7	9.6	10.0	10.1	10.6	8.3	8.5	8.4	8.4	8.4
LOANS/ASSETS	56.8	55.4	55.5	56.2	54.8	56.6	55.3	54.7	56.9	57.2
ROA	1.7	1.4	1.2	0.8	0.9	1.0	0.9	1.0	0.7	0.8
NIM	6.1	5.9	5.5	5.1	5.3	6.2	6.0	5.6	5.5	5.5

	AGRICULTURAL BANKS					NON-AGRICULTURAL BANKS				
OKLAHOMA	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.5	3.2	4.0	NA	NA	2.9	3.6	4.2
CAPITAL RATIO	9.1	9.3	9.8	9.9	10.5	8.7	8.9	9.0	8.9	9.2
LOANS/ASSETS	48.7	49.7	49.4	48.4	47.9	53.2	55.0	55.4	55.8	55.8
ROA	1.8	1.6	1.3	1.0	1.4	1.5	1.4	1.0	0.8	1.0
NIM	6.4	6.2	6.0	5.4	5.7	6.3	6.3	6.0	5.6	5.6

	AGRICULTURAL BANKS					NON-AGRICULTURAL BANKS				
SOUTH DAKOTA	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.7	3.8	5.0	NA	NA	2.0	2.1	2.3
CAPITAL RATIO	9.6	9.8	10.1	10.4	10.8	9.6	9.5	9.3	9.1	9.2
LOANS/ASSETS	50.2	49.6	50.3	51.5	52.1	57.5	57.5	53.7	56.7	57.8
ROA	1.4	1.3	1.2	0.9	1.1	0.9	0.6	0.8	1.1	1.4
NIM	5.7	5.5	5.4	5.2	5.3	5.6	5.3	5.6	5.7	6.0

AGRICULTURAL STATES SUMMARY

	---- AGRICULTURAL BANKS ----					-- NON-AGRICULTURAL BANKS --				
WISCONSIN	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	3.3	3.7	4.2	NA	NA	2.9	2.7	2.8
CAPITAL RATIO	9.4	9.6	9.7	9.8	10.1	8.6	8.6	8.4	8.6	8.7
LOANS/ASSETS	58.5	56.4	54.6	56.7	56.3	58.9	57.0	54.7	57.1	58.1
ROA	1.2	1.3	1.2	0.9	1.1	1.0	1.0	1.0	1.0	1.1
NIM	5.0	5.2	5.0	4.7	5.1	4.8	5.1	5.0	5.0	5.2

	---- AGRICULTURAL BANKS ----					-- NON-AGRICULTURAL BANKS --				
WYOMING	1981	1982	1983	1984	6-85	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	3.1	3.6	4.6	NA	NA	4.1	4.9	5.3
CAPITAL RATIO	9.7	9.6	9.7	9.6	10.2	9.4	9.4	9.2	9.1	9.4
LOANS/ASSETS	52.6	53.4	52.4	51.1	50.5	52.5	54.1	54.2	54.5	53.2
ROA	1.8	1.6	1.4	1.0	1.0	1.4	1.3	0.9	0.7	0.7
NIM	6.4	6.5	6.0	5.5	5.8	7.0	6.8	6.1	5.8	5.7

	---- AGRICULTURAL BANK[illegible] -					-- NON-AGRICULTURAL BANKS --				
STATE AVG.	1981	1982	1983	198[illegible]	[illegible]5	1981	1982	1983	1984	6-85
NONPERFORMING	NA	NA	2.7	3.4	4.5	NA	NA	2.6	2.7	2.9
CAPITAL RATIO	9.4	9.5	9.7	9.9	10.2	8.6	8.5	8.4	8.4	8.6
LOANS/ASSETS	52.6	51.3	50.6	51.7	51.5	54.6	53.4	52.3	54.1	55.0
ROA	1.4	1.3	1.1	0.8	1.0	1.0	0.9	0.9	0.9	1.0
NIM	5.4	5.3	5.2	4.9	5.0	5.3	5.3	5.2	5.1	5.2

Chairman LaFalce. Thank you very much, Mr. Meadows.

Mr. Simmons, I want to thank you for agreeing to defer your presentation so that we might ask you and other members of the panel questions directly. I appreciate that. I am going to go immediately to Mr. Carper for any questions he may have.

[Mr. Simmons' prepared statement, on behalf of the U.S. General Accounting Office, follows:]

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
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STATEMENT OF

CRAIG A. SIMMONS

ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

ON

THE FINANCIAL CONDITION OF THE FARM CREDIT SYSTEM

AND

GUIDELINES FOR CONSIDERING A RESCUE PACKAGE

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to participate in your deliberations on the Farm Credit System. The U.S. agricultural economy continues to experience severe economic difficulties two years after the end of our last economic recession. Generally, the fortunes of financial institutions mirror the fortunes of their borrowers. This is particularly true today of the Farm Credit System which lends exclusively to the agricultural sector. As a result of recent developments, the System and the Farm Credit Administration have requested federal financial assistance to restore farmer and investor confidence in the System and to permit it to carry out its mandate to provide a dependable credit source for U.S. agriculture.

In the first part of my testimony, I would like to summarize our perspective on the financial condition of the System that was issued in early October in our Preliminary Analysis of the Financial Condition of the Farm Credit System (GAO/GGD-86-13BR.) I would also like to update the information in that report through September 30, 1985. In the second part of my testimony I suggest that in considering solutions to the System's problems there are lessons that can be learned from the large scale federal financial rescues of the Penn/Central Railroad, the Lockheed Corporation, New York City and the Chrysler Corporation. The Continental Illinois National Bank rescue of 1984 also provides some lessons.

Before proceeding, I would like to emphasize that we are not taking a position supporting or rejecting the notion of federal assistance for the System. Our purpose is simply to help advance thinking about whether to provide federal assistance and, if so, how it might be structured, implemented, and overseen.

THE FINANCIAL CONDITION OF THE SYSTEM

Last month we issued our briefing report on the mid-1985 financial condition of the Farm Credit System to various Members of Congress. In that report we also projected the financial experience that might be expected between June 30, 1985 and June 30, 1986, if the deterioration in financial condition continues at its historical rate.

The financial difficulties now facing the Farm Credit System stem from the deterioration in the quality of its loan portfolio. The decline in loan quality was first felt by the production credit associations during 1982. By June 30, 1985 thirty percent of the production credit associations' loans were adversely classified. The quality of the federal land banks' loans, however, did not begin to show signs of major deterioration until early 1985. By June 30, 1985, seventeen percent of the federal land banks' loan portfolio was adversely classified. At the same time, consolidated System records showed that the amount of nonaccrual loans, i.e. loans no longer considered fully collectible and on which interest is no longer being accrued, had reached $2.7 billion.

The deterioration in loan quality has adversely affected System profitability in two ways. First, as loan quality deteriorated, nonearning assets increased, depriving the System of income from these assets. Second, as the risk of loss from bad loans increased, the System was forced to set aside a larger portion of its earnings to cover future charge-offs of bad loans. Largely because of these two factors, the System's net earnings declined from $1 billion in 1983 to $200 million for the 12 months ending June 30, 1985.

The deterioration in loan quality and its effect on earnings have caused two further problems: First, the System increased the interest rates it charges to reverse the decline in income. These rate increases together with the risk of loss of the borrowers' investment in association stock and the fact that interest rates elsewhere are declining, may be influencing the more creditworthy borrowers to leave the System. The System's outstanding loans decreased by $3.1 billion, or about 4 percent during the first 6 months of this year. We do not know precisely how much of the decline in loan volume is due to charge-offs of bad loans versus loss of good borrowers. But System officials have expressed concern about the competitiveness of the System's interest rates and the effect that these rates have had on its better borrowers. The loss of the more creditworthy borrowers would materially hurt the System's ability to generate income to absorb continued losses.

Second, in July, 1985, investors began to require a premium on System securities. By the end of September, the System's securities were priced about one percentage point higher than comparable Treasury securities. In October, this trend continued and the System encountered some resistance to marketing long term securities. During the next five months the System estimates that it will need to market $8.4 billion to replace maturing bonds and it will increase its discount notes from $9.9 billion to $10.7 billion. If the premium attached to these securities continues to increase, it will be difficult to pass this cost on to existing borrowers.

Despite these negative financial indicators, as of June 30, 1985, the System had $7.5 billion in earned surplus and reserves available to absorb losses. A major concern, however, is the rate at which the System appears to be deteriorating, and its ability to reverse these trends.

Based on these trends we extrapolated, in our report, that nonaccrual loans would reach $6.1 billion by June 30, 1986. The loss of earnings and provision for loan losses would have devastating effects on the System's profitability. To set up an appropriate reserve for loan losses by June 30, 1986, we projected that at least half and possibly all of the earned surplus built up from prior year's earnings would be needed. While the System would still be solvent, its ability to absorb future losses would be materially reduced.

PRELIMINARY RESULTS FOR THE THIRD QUARTER

We have not completed our analysis of third quarter System results because financial data from all reporting institutions was not furnished to the Farm Credit Administration until this week.

Nevertheless, there are several things that are obvious at this point. Key indicators of financial condition show a continuing deterioration in the System. During the third quarter

--Gross loans declined by 5.5 percent from $80.4 billion to $76 billion.

--Nonaccrual loans increased by 63 percent from $2.7 billion to $4.4 billion or 5.8 percent of gross loans.

--Most of the increase in nonaccrual loans occurred in the federal land banks. During the three-month period their nonaccrual loans increased by 78 percent.

--Short term debt increased by 25 percent from $5.9 billion to $7.4 billion or 10.9 percent of the total debt increasing the System's vulnerability to interest rate swings.

--Earned surplus declined by 12.7 percent from $6.3 billion to $ 5.5 billion.

The figures that I have just cited seem to indicate that the System is deteriorating at a faster rate than we projected based on our extrapolation of the trends as of June 1985. However, because we have concerns about the quality of data reported to the Farm Credit Administration, we are not certain whether the System is actually deteriorating at a faster rate or whether the data reflects a recognition at this time of problems that existed in prior periods.

With no reversal in current rates of deterioration in the quality of the System's loans, capital will eventually be wiped out. No one is sure how long it will take for this to occur.

Nevertheless, even though the depletion of capital, by itself may not cause an immediate financial crisis, it could result in a loss of investor confidence in System securities at any time, causing a funding crisis.

WHAT OUR EXPERIENCE WITH PAST FINANCIAL RESCUES SUGGESTS ABOUT POSSIBLE APPROACHES TO RESOLVING FARM CREDIT SYSTEM PROBLEMS

At this point I will turn to the second part of my testimony. In March of last year GAO published its report entitled Guidelines For Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34). This report assessed the experience with the government's rescue of the Penn/Central Railroad (later Conrail), the Lockheed and Chrysler Corporations, and New York City. Each assistance program had a different justification and each was structured somewhat differently from the others. Although each program was unique, together they taught us much about appropriate responses to requests for federal financial assistance. Also, last December, GAO submitted testimony to the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance which, in part, assessed the rescue of the Continental Illinois National Bank in the context of the guidelines.

It strikes us that these guidelines provide an appropriate framework within which to think about a financial rescue of the Farm Credit System.

CRUCIAL CONSIDERATIONS

Past experience has taught us that there are four essential areas to be explored when considering a rescue of the Farm Credit System.

--First, the problem to be solved must be clearly defined as quickly as possible. What are the precise causes of the System's problems? If we do not define the problems correctly, the rescue package we design may fail to address root cases and thereby provide only a temporary solution.

--Second, the national interest must be clearly established. Why is preserving one particular private sector institution --the Farm Credit System-- important to our agricultural and national economies? How does the cost of saving it compare with the cost of letting it fail?

--Third, the goals and objectives associated with the response should be clear and non-conflicting. Are we more worried about the health of the System's borrowers or the fortunes of its lenders? There may be an inherent conflict between the goal of providing farmers with a ready source of credit at the lowest reasonable cost and the goal of maintaining a safe and sound credit system. Trying to accomplish both goals in one program could prove counterproductive by preventing our achieving either.

--Fourth, the government's financial interests must be adequately protected and to the extent it is practical, all parties with an interest in seeing the Farm Credit System survive must have appropriate incentives to contribute to the program's success. Who has a financial interest in the System's survival? Are there incentives for them to share in the cost of the rescue package? What types of collateral are available to secure the government's investment in the System? What form of risk compensation should the government receive for the aid it provides?

Let me discuss in a bit more detail our preliminary thoughts on how these four guidelines relate to potential program designs for solving the problems of the Farm Credit System.

Defining the Problem

While there has been much discussion of the nature of the problems facing the Farm Credit System there is still one fundamental unanswered question. Precisely how much of the System's problems are its alone and how much are due to the larger problem facing the agriculture sector? Clearly, some of its problems are due to poor internal management and oversight practices. An assistance package could be an effective vehicle for obtaining needed internal reform. In this regard, we note that the Farm Credit Administration is proposing a considerable strengthening of its supervisory and enforcement powers over the System's institutions as well as actions to pool the System institutions' capital and reserves as a prerequisite to obtaining a borrowing line with the Treasury.

It is equally clear that many of the farm Credit System's problems mirror broader problems in the agriculture sector. The System is likely to continue to experience stress if farmers remain highly leveraged and their incomes and land values continue to decline.

Unlike the problems experienced by Chrysler which were due, in part, to recessionary forces which were temporary in nature, it is difficult to see exactly how and when the agricultural sector's current problems will end. Nonetheless, federal aid to the System structured without regard to the longer term adjustments necessary to restore the health of the agriculture sector may provide only a temporary solution for the System.

Determining the National Interest

Fundamental to the issue of whether providing aid to the Farm Credit System is in the national interest and how such aid should be structured are two basic sets of questions.

--Does the System continue to provide unique sources of financing to the agricultural sector or can it reasonably be expected that if it were shrunken in a controlled manner over a number of years its activities would be picked up by other financial institutions?

--How much would a rescue package cost and how do these costs compare with those that would result if federal aid was not provided?

It makes little sense to consider the specifics of a rescue package until we have answers to these questions. If Congress decides, for example, that the role now played by the Farm Credit System can be played by other private sector institutions, then it may need to legislate a program to achieve an orderly winding down of the System's operations. The structure of an assistance package to wind down operations would differ from the structure of a rescue package designed to ensure the System's continuance.

With regard to the second question, we need to learn more about how seriously a default on the System's bonds would jeopardize the financial viability of its lenders, what the implications of a default would be for the System's borrowers, and how serious the spillover effects throughout the economy would be. In the Continental Illinois case there was concern that the spillover effects on smaller banks, which had a business relationship with Continental, and on larger banks were too severe to let the bank fail. In Chrysler's case, adverse effects of its failure on suppliers and others having a business relationship with the company as well as social costs such as lost employment were believed to be larger than the amount of aid being contemplated. Can the same be said for the consequences of a default of the Farm Credit System? Although we have not done a detailed analysis ourselves it seems clear that should an unexpected default occur the effects would reach beyond the System itself and could be very serious.

In addition to these considerations, we also need to consider the effect that saving the System might have on its competitors. Aiding the System will weaken market discipline if a perception is created that government aid will be available to rescue firms that get into financial difficulty as a result of their business decisions. This has been a concern in all past programs. It was dealt with in past programs by imposing requirements on the aid recipient that were sufficiently stringent that other potential recipients would view federal aid only as a last resort measure to be avoided if at all possible.

Clear and Nonconflicting Program Goals

While it may seem obvious that as a matter of principle, the objectives of an aid program should be clear and nonconflicting, this has not always been the case in past large scale financial rescues. For example, was the major intent of the Conrail program to save jobs, preserve rail service or restore profitablity? For a number of years the answer to this question was unresolved and it caused problems. Without knowing the primary objective of an aid program, problems can be perpetuated, it will be difficult to decide what program design features are necessary, and it will be hard to judge whether the program is succeeding. Should a program for the Farm Credit System be designed to save farming operations, restore a sound, prudently managed System, protect investors, or preserve the existing System institutions? These objectives probably cannot be mutually satisfied.

Protecting the Government's Interest

If we decide to aid the Farm Credit System because

--saving it is an important component of a broader policy for dealing with the Farm Sector's problems,

--it will continue to provide a unique source of financing to agriculture,

--it is unlikely that the System, on its own, can save itself, or

--the financial repercussions of a failure exceed the costs of providing assistance

the government's financial interests should be protected to the maximum extent possible.

The Farm Credit System _is_ a private organization. Therefore, a rescue program should be designed to provide as much assurance as possible that the assistance will be repaid. If this prospect is not good, then nationalization is one alternative. I noted earlier that the Farm Credit Administration has proposed an increase in its supervisory and examination powers and a mechanism for pooling its capital. There are additional ways to increase the prospect of repayment that have been used in past programs that may be useable in a program for the Farm Credit System.

Concessions from those with a financial stake in the entity

In the Chrysler, Lockheed, and New York City situations, the government required concessions from those with a financial stake in the resolution of each entity's respective problems as a prerequisite to providing Federal assistance. Such concessions reduce the federal government's risk exposure, help the program appear fair, and create appropriate incentives. But, we emphasize in our report that affected parties will cooperate only if the program offers a better alternative than restructuring or liquidation. We should not expect investors, for example, to make concessions that will cost them more than they expect to lose through eliminating their relationship with the firm on their own, or through restructuring or liquidation.

In the case of a financial entity, concessions may be more difficult to obtain or prove to be of less significance than in the case of a major manufacturing firm or municipality. In Continental's case, for example, depositors had no incentive to maintain their relationship with the bank once its problems became known. It was virtually costless for them to transfer balances to another institution. In the System's case, it is not clear what incentives there might be for investors to sacrifice something of value but it is an area worth exploring. However, even if investors were willing to go along with such a program it could change investor's perception of other "agency" status debt; potentially raising interest costs on that debt.

Others that might be asked to participate in a program of concessions are the System's employees. While employee concessions were a major factor in saving the Chrysler Corporation, in the case of a financial entity these types of concessions cannot be expected to provide a major source of assistance. Nevertheless, they should be required because of their symbolic value. State and local governments are another possibility for participation in a plan to revitalize the System. Finally, elimination of management perquisites, as occurred in Chrysler case, is another important symbolic concession.

Controls over management

The Congress should protect the government's interest by creating a mechanism through which the assistance program will be administered and overseen. It is essential that the System develop operating and financing plans which show how it intends to maintain viability and that these plans be independently reviewed and approved as a condition of assistance. These plans are important because they will guide the System's operations and, thus, its future financial condition. Therefore, they must be subject to governmental review and approval. It is also important that major contracts or other important structural changes in operations be reviewed and approved by the government.

This element has been a central feature of all large scale federal financial rescues and we see no reason why it should not be incorporated into any rescue proposal for the Farm Credit System. It provides a source of objective outside discipline. This requirement along with increases in examination and supervisory responsibilities for the Farm Credit Administration, pooling of capital resources, loss of management perquisites, and, presumably, the power to remove officers result in a significant loss of management autonomy. And, this loss of autonomy is an important concession that the government can require of System management and its constituent institutions.

Collateralization of federal investment

In our report we also indicate that the government should require, when feasible, that the assisted entity maintain adequate collateral and that all other lenders subordinate their claims to the government's. In the New York City case, requiring collateral was not feasible; but in the Chrysler and, initially in the Continental case the government's investment was fully collateralized. Whether this can be done in the case of the Farm Credit System is uncertain at this time. Its feasibility depends on whether the System's investors would be willing to relinquish first claim on the System's loans and on what premium such investors might require for doing so.

Risk compensation

Finally, as in past programs, the government should receive risk compensation in return for federal aid, particularly if the program succeeds in restoring financial health. Fees are one possibility worth considering but they should not be set at a level representing full risk compensation. Fees set at that level, if passed through to the borrowers as higher interest rates, could be counterproductive. For this reason, some form of equity participation by the government in the gains of the System if the program proves successful would seem most appropriate. This form of risk compensation was used in the Chrysler case and was also an important part of the rescue package for the Continental Illinois National Bank.

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I would like to conclude by emphasizing the following points:

--We can never be certain that a particular rescue program will succeed, but past experiences have taught us how to design those programs in a way that gives us the greatest assurance of success.

--The strings attached to any rescue program should not be so onerous as to impede success. On the other hand, they need to be stringent enough to discourage other private firms and institutions from seeking federal aid.

--Finally, we may find that there are, for example, few opportunities for significant risk sharing. We may also find it is impossible to settle on a single objective or mutually compatible objectives for a rescue program. Thus, past experience may not prove completely relevant to the problem we are discussing today. But the Farm Credit System is a private organization, and good public policy dictates that we make a concerted attempt to seek answers to the questions that have been addressed in past rescues of major failing entities. If we do not do this, and simply provide cash infusion to the System with no definition of what we hope to ultimately accomplish or avoid, or if we do not explore possibilities for contributions by financially interested parties and protection of the government's interest, we run the risk of setting a dangerous precedent which, over the long term, could prove very costly.

Mr. Chairman, this concludes my prepared statement. I will be happy to respond to any questions that you or other committee members might have.

Mr. CARPER. I have no questions at this time.

Chairman LAFALCE. Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Mr. Fiechter, I find your presentation to be very disappointing. I think you ought to look at a whole region of the Nation that has trouble. To come here and give us some observations based upon nationwide conditions is not very helpful.

The Congress has for long periods of time found it to be appropriate public policy to assist a region that is affected by natural disasters, or to assist a region that is suffering greatly from economic conditions through such programs as the TVA. We have precisely that condition in the western Grain Belt today.

I must also say, Mr. Meadows, you too are looking at it on a systemwide basis which you admit. In doing that you ignore very real problems that exist when whole States are in deep trouble. I also think it comes close to distortion when you say you have yet to see a bank failure which can be solely attributed to economic problems. There will always be an incidental problem or two when management decisions can be pointed to as inappropriate. Of course, what looks like an appropriate decision in 1979 may not look to be such a decision in 1985.

I do not find the hearings to be very helpful today, Mr. Chairman.

Chairman LAFALCE. All right, thank you. Let me just ask a few questions on the Federal Reserve. Would there be any difference between financial assistance given from the Federal Reserve and given from the Treasury, if assistance were to be given to the Farm Credit System?

Mr. AXILROD. One difference that immediately comes to mind is any lending by us adds immediately to the reserve base of the banking system, and we would have to offset it through open market sales of Government securities. That is a principal difference. There probably are differences in budgetary impacts also. In addition, Federal Reserve credit can be supplied for liquidity purposes, not as long-term capital.

Chairman LaFalce. Would it be any more inflationary to make assistance through the Federal Reserve than through the Department of the Treasury?

Mr. Axilrod. Oh, yes, it would be more inflationary in that it adds—that act alone adds to the reserve base and credit and money of the country. It is a new addition, whereas for the Treasury, it would be money cycled from someone else.

Chairman LaFalce. Does counsel have a question he would like to ask?

Mr. Price. The Federal Reserve could not offset that inflationary effect otherwise?

Mr. Axilrod. I answered in the first question you would have to offset it by sales of Government securities, but the act as such adds to reserves.

Chairman LaFalce. Wouldn't you automatically offset it?

Mr. Axilrod. To the extent consistent with the decision made by the FOMC, it would be offset, certainly.

Chairman LaFalce. If that were done, it would not be any more inflationary.

Mr. Axilrod. Unless you are talking about dimensions that were so large as to begin making it practically difficult to sell that amount of securities.

Chairman LaFalce. Suppose we were dealing in dimensions not to exceed $3 billion?

Mr. Axilrod. That is not a practically difficult area.

Mr. Price. What the Farm Credit System testified this morning was that over the course of a year they might draw on $1½ billion from the Treasury. If they were to draw on that level from the Federal Reserve, that should not be inflationary, should it?

Mr. Axilrod. No. You use the word "draw." It is as if they have a draw, but I do not think they have a draw. To get money they would have to meet those standards of lending that are set up in the Federal Reserve Act and in the regulations. They do not have a draw on the Federal Reserve.

Chairman LaFalce. Would Federal Reserve assistance either to Farm Credit System or to ag banks have to be public?

Mr. Axilrod. Well, we publish every week the amount of borrowing in our balance sheet and so any large amount becomes clear.

Chairman LaFalce. Those are aggregate amounts though.

Mr. Axilrod. Yes, that is right, but the average level of borrowing runs, well, recently 4, 5, 6 hundred million; so if you had a sudden surge like in the Continental-Illinois case——

Chairman LaFalce. If you did it all in one fell swoop, yes.

Mr. Axilrod [continuing]. And in addition, as I think I explained in my testimony, if the borrowing got sizable enough, it would probably fall into an emergency provision of the Federal Reserve Act, which would require a five-person vote of the Board—which would be a public policy decision.

Chairman LaFalce. So in all likelihood it is going to become public one way or the other.

Mr. Axilrod. Oh, yes.

Chairman **LaFalce**. Then how would the bond holders and depositors perceive such an intervention?

Mr. **Axilrod**. That is a very speculative question, Mr. Congressman, and it would be most difficult to respond to it because you would have to really know what was going on at the time. I think at the moment the possibility of support to the Farm Credit System has been a stabilizing factor in their ability to issue and market debt. If it ever got to the point, which I would not necessarily expect, of their having to borrow from the Federal Reserve, that would be under a condition where the market itself had already, in effect, begun to close up to it. So you would be having a condition which was, in effect, worse than you have now.

Chairman **LaFalce**. It is fairly clear that the Federal Reserve would not give assistance unless there were adequate collateral, correct?

Mr. **Axilrod**. That is correct.

Chairman **LaFalce**. I would assume that any legislation that would pass through the Congress, if any would, would demand that the Treasury have adequate collateral also. How would you evaluate the collateral of the Farm Credit System today?

Mr. **Axilrod**. Well, the Farm Credit System, as you know, has announced a certain amount of losses, which is well known to the market. We have not been able to evaluate their credits in any detail at all at this point, and I would not be in any position to go beyond what has already been announced by the System itself, which I think has been very forthcoming.

Chairman **LaFalce**. Mr. Axilrod, some previous witnesses have testified that bond holders could become skittish about the Farm Credit System just as depositors have done on uninsured banks. Is there any reason for the Fed to make any distinction between the Farm Credit System and uninsured banks insofar as operating the discount window is concerned?

Mr. **Axilrod**. No. In the section B provision, we would not make a distinction. In terms of the section 13(3) which requires this five-person vote of the Board and finding unusual and exigent circumstances, that is where the Farm Credit System——

Chairman **LaFalce**. What has been the historical position taken by the Reserve with respect to uninsured banks that have sought Fed assistance?

Mr. **Axilrod** [continuing]. Most recently——

Chairman **LaFalce**. Have you found unusual and exigent circumstances?

Mr. **Axilrod** [continuing]. Well, 13(3), a loan was made to a nonmember bank in the mid-1900's, in exceptional cirumstances. Nonmember banks did not have ordinary access to the discount window. At present, nonmember institutions which have reservable deposits do have ordinary access. In earlier periods, some nonmember institutions were given access, but I think they were probably insured at that time. I do not believe the Board had occasion at that point to discuss uninsured institutions, but they certainly could be considered under 13(3) in unusual and exigent circumstance.

Chairman **LaFalce**. What I am trying to do is to get a handle on the precedents that you might look to for determining whether unusual and exigent circumstances existed, especially with respect to the uninsured banks, because I think uninsured banks in the Farm Credit System might stand in paridelecto.

Mr. AXILROD. As you know, the world has changed greatly. The U.S. economy and financial markets have changed greatly, and I think that the Federal Reserve in coming to its decisions about such things would take account of present circumstances as well as precedents.

Chairman LAFALCE. Mr. Meadows, a lot of you will say we have yet to see an ag bank fail, strictly because of their ag loans. What were the primary other problems of those ag banks that failed? And to put the question another way, why are there a good many ag banks in Iowa and Nebraska, for example, who are doing extremely well or at least well?

Mr. MEADOWS. Mr. Chairman, I think the statement that we have made is that the banks with good managements have not failed, that we were attributing the failures to weak managements. I think what has happened is that the weaker borrowers, when adverse economic conditions come to the front, as they have in the farm sector, the weaker borrowers naturally are the first to suffer. The banks or the financial institutions that made loans to these weak borrowers are probably the first to suffer and probably the first to fail; but what we are indicating now is that if this continues, other banks, the well-managed banks, are starting to experience some of the same problems. Some of the better farm borrowers are gradually experiencing the same difficulties that the weak borrowers were.

I think there was a second part to your question. I do now know if I answered that or not.

Chairman LAFALCE. Pardon?

Mr. MEADOWS. Was there a second part to your question that I did not answer?

Chairman LAFALCE. Mr. Fiechter, I think, wanted to make a comment.

Mr. FIECHTER. No.

Chairman LAFALCE. You have noted that commercial banks have total assets of $2.6 trillion, and that the 50 ag banks that have closed this year had assets of almost $1,871,000,000. The actual losses must be considerably smaller than that. Do you have any idea of the size, the actual size of the losses?

Mr. MEADOWS. You are speaking of the losses in the ag banks that failed this year?

Chairman LAFALCE. Yes.

Mr. MEADOWS. No, sir. I think it is probably a little bit early to determine what our actual losses will be in the various banks which fail this year. Historically, however, there is significant recovery on the——

Chairman LAFALCE. What is the historical recovery percentage?

Mr. MEADOWS [continuing]. I do not have the exact figures, but we were looking yesterday at some banks which failed in the period 1980 to 1983, and, at this point in time, the recoveries in those particular banks ranged from 59 to 95 percent, and probably in the long run it would be closer to the 95 percent than 50.

Chairman LaFalce. Closer to the 95 percent. Your distinction is between immediate recovery and long-term recovery?

Mr. Meadows. It takes a great deal of time to achieve recoveries, but historically the FDIC——

Chairman LaFalce. Your loss usually winds up to be around 5 percent.

Mr. Meadows [continuing]. I am not sure if that is an accurate figure or not. It probably will be higher than that overall.

Chairman LaFalce. I would ask you to flesh this out in writing with as much precision as you could because it would be interesting to find out of all the ag banks that have failed this year what our real losses are going to figure out to be based upon, at least, the historical pattern. If their total assets come to $1,871,000,000, and we wind up with a 95-percent recovery or 5-percent loss, we are looking at a loss then of around $40 some million which seems to be manageable.

Mr. Meadows. Offhand I would say the loss would probably be higher than that, Mr. Chairman, although still very manageable.

Chairman LaFalce. What would you say, from $40 million to maybe 10 percent would be closer to between $80 and $100 million?

Mr. Meadows. Possibly less than $100 million, yes.

Chairman LaFalce. Are there larger banks being hurt by the closures of ag banks because of their financial ties to them?

Mr. Meadows. Are larger banks being hurt as it applies to the agricultural banks?

Chairman LaFalce. Yes.

Mr. Meadows. I am not aware of specific situations where large banks have been harmed by the failure, so to speak, of smaller banks. Larger banks do participate in loans with——

Chairman LaFalce. They have probably been hurt. The question is the extent of the injury. Are you saying that whatever injury there has been in your judgment probably has not been that grievous?

Mr. Meadows [continuing]. I am not aware of any significant loss.

Mr. Bereuter. Mr. Chairman, would you yield on that point?

Chairman LaFalce. Yes.

Mr. Bereuter. Thank you for yielding.

I can give you quite a few examples from the Great Plains of banks that have many correspondent banks with 25 percent of their loan portfolio in agricultural loans which have been substantially hurt by the condition of their agricultural banks since they share in the loans. For anyone to suggest otherwise indicates to me you do not understand what is happening in the Grain Belt. I can give you several examples from Iowa and Nebraska alone.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you.

How many towns have lost their only bank because an ag bank has closed and not been reopened?

Mr. Meadows. I think this year we have had approximately 11-deposit payoffs of farm banks or agricultural banks. I am not sure how many were the only bank in town. There have been several, and in almost every case we attempted to arrange a purchase and assumption transaction.

Chairman LaFalce. Of the 50 banks that have closed, how many have either been reopened or purchased by some other institution?

Mr. Meadows. Eleven have been insured deposit payoffs, 11 of the 50.

Chairman LaFalce. That means they have not been reopened?

Mr. Meadows. They were not reopened.

Chairman LaFalce. Insured deposit payoffs.

Mr. Meadows. Although one of those, I believe, was an insured deposit transfer where we transferred the insured deposits to another bank in the community or around a neighboring community. The other 40 did reopen.

Chairman LaFalce. The other 40 all reopened?

Mr. Meadows. Yes.

Chairman LaFalce. None involved purchases by someone else?

Mr. Meadows. They were purchased by another party and operated either as a new bank or as a branch of another institution.

Chairman LaFalce. All right, fine, so we are really only talking about 11 then or 10?

Mr. Meadows. I would say 10, yes.

Chairman LaFalce. What is the total number of ag banks in the country that are not federally insured—do you have any idea?

Mr. Meadows. I have no information about agricultural banks that are not federally insured. They would be very few, I would think.

Chairman LaFalce. Mr. Simmons, if the Congress decides that we are going to have to come up with financial assistance in some form or permit the Treasury to give financial assistance or if the Fed should give financial assistance, I have concerns about setting precedents for other financial institutions who want to sell their bad loans to a federally sponsored warehouse. Since top management in these other institutions will decide whether they will pursue congressional help, I would be particularly interested in an appropriate sacrifice by top management in the Farm Credit System and Farm Credit Administration. Do you have any suggestions for sacrifice by them that might work as well as the Chrysler conditions did with Iaccoa?

Mr. Simmons. I think, Mr. Chairman, based on what we have learned in the past in this particular area, given that your concern is what the incentives of managers of institutions might be to jump on the animal we might create, that there are quite a few incentives. Past history has taught us that one of the most important things we need to do in these programs in order to avoid setting a precedent is make it a very tough proposition.

The problem with making it a very tough proposition is that you run the risk of creating a situation where you impede the return of the Farm Credit System or anyone else you want to assist viability to. In fact, you might make the situation worse. In terms of specific things that I think ought to be done to discourage management of other institutions from coming forward with requests for Federal aid, I would certainly require business and operating plans as have been required in past programs subject to governmental review and approval as a condition for assistance. I would also require a number of other reporting requirements that would be viewed as quite onerous.

They certainly were required in the Chrysler case, but were necessary for the Government to monitor the financial condition of the firm.

I would do everything I could to eliminate management perquisites. In terms of the statement that was made by Lee Iaccoa, I can only tell you that when we or when Secretary Miller of the Treasury took his airplanes away, I think that had a more devastating effect on the way he felt about the whole program than everything else that had happened before that. Those are really the things that get at the issue of managers' incentives. There are a number of other things that have been done in past programs that I think might also be relevant; but in terms of sacrifices by management, bascially what we have learned in the past is it is important that management autonomy be relinquished during the program and, of course, in the case of private enterprise eliminating management autonomy is a very painful experience. So those would be my preliminary suggestions.

We plan on continuing to study the options for the Farm Credit System based on our experience in the past over the next 3 to 4 months, and I would be glad to give you the benefit of our thinking at the end of that period.

Chairman LaFalce. Thank you very much.

I would like a laundry list suggested by you of the type of conditions that you would deem appropriate if we were to go forward to give assistance.

Mr. Simmons. You would like me to comment on what I think might be appropriate?

Chairman LaFalce. Yes.

Mr. Simmons. At this point?

Chairman LaFalce. Not at this point. I would like you to flesh that out in writing if it is not included in your statement.

The bill before the Agriculture Committee, as I understand it, gives basically an open-ended $3 billion line of credit. There is no cap on it? It does not even say $3 billion? An open-ended amount of credit available to the Farm Credit System from the Treasury. Do you think that is wise?

Mr. Simmons. Mr. Chairman, I think that would be a big mistake. Again, relying on history, the Chrysler guarantee program had $1.5 billion worth of loan guarantees. The New York City Program offered $2.3 billion worth of seasonal financing, and then later on, $1.6 billion in long-term loans. The Conrail Program was sort of open-ended, and I think the Conrail experience teaches us what we should not do with regard to the Farm Credit System or any other system. Lockheed had $250 million in borrowing authority, so I certainly do not think it should be open ended. I have absolutely no idea what it should be. I have heard figures from $10 billion to $6 billion and now $3 billion. I do not know what the right number is.

I think it is extremely important that a repayment provision be associated with whatever the line is. In the Chrysler case, for example, the corporation could only draw down the $1.5 billion for the first 3 years of the program, and the loan guarantees had to be repaid by 1990. They paid them back much sooner than that. Lockheed did too. But I think it is very important that there has to be a cap, and there has to be a repayment period.

Chairman **LaFalce**. Are there any types of demands that we could make upon those related to the Farm Credit System that would benefit from financial assistance that would be counterproductive?

Mr. **Simmons**. In terms of creating a situation where you might make the System less viable, I think we have some concerns. I do not think that you can rely totally on the Chrysler experience and totally on everything we have learned in all the other experiences to deal with the Farm Credit System's problems. The Government required collateral in the Chrysler case. It required collateral in the case of Lockheed. We are studying the feasibility of requiring collateral, that is, the Treasury or whoever oversees this program requiring collateral. We have some concerns about how that might affect investors' perceptions of Farm Credit System securities as well as what the perceptions are that might be created about other agency debt.

We are concerned about what is left to extract from farmer borrowers. We do not know whether there is anything left to extract. We think that might be counterproductive. It seems to me that if we require risk premiums as we did in previous programs they should not be set too high because if they are, they will be passed on to farmer borrowers. The good borrowers who are already leaving the system to an indeterminate extent will leave the system at a faster rate. The marginal borrowers and the borrowers that are in severe financial difficulties right now will simply have their problems exacerbated.

The Farm Credit System is different. It is a financial intermediary. It is not a Continental-Illinois and it is not a Chrysler Corp. It is somewhere in between, and there are a number of things that we need to think through; and as I indicated, we plan on thinking about them over the next 3 months to decide on what might be appropriate and what might not be appropriate in this particular case.

Chairman **LaFalce**. Mr. Fiechter or Mr. Meadows, do you think it would make much sense to give assistance to the Farm Credit System, if we did not give assistance to ag banks?

Mr. **Fiechter**. I would like to take this opportunity to both answer your question and to respond to Mr. Bereuter's concerns. With respect to Congressman Bereuter's earlier comments, I do not at all want to suggest that the Office of the Comptroller of the Currency does not recognize the severity of the ag bank problem. About 12 percent of the 850 national ag banks are considered to be problem national banks. We take that seriously. We also recognize that those banks are concentrated in about 11 States in the Midwest.

The question that I was responding to in the testimony was whether or not we thought the present financial condition of ag banks had reached the point where we thought it was appropriate to support Federal financial assistance to that segment of the commercial banking system. We recognize that the problems are severe, particularly in those Midwestern Corn Belt States. We do not feel, however, that the problem has reached the point where scarce resources should be injected into that particular segment of the banking system.

To respond to your question, Congressman LaFalce, from a safety and soundness standpoint, we do not think Federal assistance is necessary. Personally, however, I believe that in our system where farm credit agencies are competing against banks, if Congress assists one type of lender, from an equity standpoint, it would seem appropriate to bail out other lenders making ag loans as well. But from the standpoint of safety and soundness, we do not think it is necessary to provide Federal assistance to national agricultural banks.

Chairman **LaFalce**. For ag banks?

Mr. **Fiechter**. For ag banks or for the other problem banks, the nonag banks, that are also on our list.

Chairman **LaFalce**. Do you have any judgment at all as to whether it would be necessary for the Farm Credit System, or is that beyond your area?

Mr. **Fiechter**. That is out of my area of expertise.

Chairman **LaFalce**. Is it within the area of any of the panelists today to make a judgment whether Federal financial assistance either through the Federal Reserve or through the Treasury should be an option for the Farm Credit System?

Mr. Axilrod.

Mr. **Axilrod**. I do not have any judgment on that at this time, Mr. Chairman, but I have described the conditions at which there is access to the Federal Reserve bank.

Chairman **LaFalce**. Mr. Meadows.

Mr. **Meadows**. No, sir, I have no views on that, although I agree with my colleague from the OCC. We do not think from a safety and soundness standpoint that assistance to agricultural banks is necessary.

Chairman **LaFalce**. Mr. Simmons.

Mr. **Simmons**. I did not come here today to support or reject the notion of Federal assistance to the Farm Credit System. My point was mainly that if it is decided that it has to be done, that from a matter of good public policy, it needs to be done so that we can avoid setting a precedent. I am not in a position right now to comment on whether we should or should not provide it.

Chairman **LaFalce**. Fine, thank you.

There are no further questions. Gentlemen, we may submit further questions to you in writing and ask you to respond to them in writing. We will leave the record open for that purpose; but because of the time of day, the subcommittee will stand in recess. We thank you very much.

[Whereupon, at 4:05 p.m., the subcommittee was adjourned.]

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